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ISDA

Accounting for Cross-product Netting

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EXECUTIVE SUMMARY

In February 2022, ISDA published the 2022 ISDA Securities Financing Transactions Definitions[1] and related documents. The launch followed an ISDA whitepaper in October 2020 that highlighted significant opportunities for alignment between derivatives and securities financing transactions (SFTs). These documents allow parties to document stock loans, repurchase transactions and derivatives as part of a single close-out netting arrangement under an ISDA Master Agreement, confirming the enforceability of set-off rights, which enable counterparties to exchange a single net payment across products in the event of a default or termination.

The introduction of set-off rights across products has significant consequences, creating the necessary legal framework to align market practices and bring improvements across legal, accounting, risk, capital, collateral and operational processes. The impact on those functions should be carefully considered when using the ISDA SFT documents.

This paper provides an overview of the background and scope of the ISDA SFT documents, including the near-term benefits of product agnostic agreements, which allow counterparties to net settle SFTs and derivatives in the event of a default. The paper is intended to educate readers on the accounting and reporting implications under US Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS). It describes the balance sheet offsetting requirements under US GAAP, where there are some exceptions to the requirement to demonstrate intent when there is a master netting agreement in place, and under IFRS, where there is a requirement to demonstrate the intention to offset in all circumstances, not just in the event of default.

The paper also provides an illustrative example of the economics and benefits of using ISDA's SFT documentation and demonstrates the legal right to set off across products, where a dealer and customer enter into a securities lending transaction and a derivatives transaction. This example demonstrates how the economics of a single close-out provision across products with the same counterparty can provide risk management benefits.

Extrapolating on this example, the paper explores the beneficial practices that could develop as the market adopts cross-product netting, such as collateral optimization. With various products subject to the same master netting agreement, and potentially the same collateral agreement, there is an opportunity to further optimize the collateral posting process by only requiring one net amount to be posted across all products with the same counterparty. More efficient posting of collateral can ultimately contribute to a more stable financial system.

[1] ISDA Publishes Documentation to Align Derivatives and SFT Markets, February 28, 2022, www.isda.org/2022/02/28/isda-publishes-documentation-to-align-derivatives-and-sft-markets/

ISDA CROSS-PRODUCT NETTING AGREEMENTS

The ISDA Securities Financing Transactions Definitions and SFT Schedule Provisions allow institutions to enter into derivatives and SFTs under a single ISDA Master Agreement, streamlining legal documentation and enabling more effective management of counterparty credit risk.

Net Exposure and Settlement

The ISDA SFT documents build on the ISDA Master Agreement, providing the legal framework for representations and warranties, close-out mechanisms, events of default and other relationship-level contractual agreements across stock loans, repurchase agreements and derivatives. The documentation allows multiple products and transactions to be combined, resulting in a single net exposure and net settlement, while also harmonizing certain close-out provisions for the different products in the event of default or bankruptcy.

Legal opinions allow for a single net payment between counterparties. By using the ISDA SFT documents, parties can more easily negotiate bespoke structured transactions without making substantial changes to the ISDA Master Agreement. Under the existing legal framework, the same terms may exist in each SFT and derivative, but they are not always defined in an entirely consistent manner across each document, creating ambiguities and compliance challenges.

In a default scenario, the ISDA SFT documents allow close-out netting across portfolios of both SFTs and derivatives, while retaining the key economic differences between the portfolios. The creation of a single netting set prevents the defaulting party from attempting to 'cherry pick' the contracts it will collect or pay out under. For example, an insolvent party might attempt to collect on transactions that are in the money where they are owed, but disclaim contracts where payments are due.

In certain scenarios, such as a force majeure event that has a significant impact on the trading relationship but does not involve a default, the ISDA SFT documents allow the flexibility, where appropriate, to close out SFTs without closing out the derivatives in the portfolio, and vice versa. Current practice generally dictates that failure to deliver securities is not an event of default that could trigger termination of all transactions under that master agreement but enables the other party to elect to close out the relevant transaction. This is an important economic feature and the ability to make these elections with respect to SFTs is retained in the ISDA SFT documents.

Under the ISDA Master Agreement, an event of default with respect to one party enables the other party to designate an early termination date that applies to all transactions under that agreement. However, if parties wish certain events to only trigger the termination of either SFTs or derivatives transactions under the agreement, this can be addressed by making elections under the SFT Schedule Provisions.

Under the existing legal framework, since SFTs and derivatives are documented under separate master agreements, separate negotiations and agreements are required to determine the close-out amount for each. Following an event of default, a single early termination amount is calculated for all derivatives and SFT transactions under the agreement.

Simplified Risk Management

Recent global events such as the COVID-19 pandemic and Russia's invasion of Ukraine have caused significant market turmoil, prompting institutions around the world to assess the termination provisions in many of their legal contracts and to seek to determine in short periods of time the net exposure at the counterparty level.

These events have highlighted the increased risks that exist in difficult economic times that can be addressed through streamlined and standardized documentation. Using the ISDA SFT documentation would greatly simplify the analysis of close-out provisions, particularly at times of stress, across transactions.

By introducing set-off rights in the event of default or bankruptcy, these agreements simplify counterparty risk management. The ISDA Master Agreement is a product-agnostic framework that focuses primarily on the management of counterparty credit risk.

Cross-product netting allows for simplified risk management across exposures with the same counterparty. For example, in the event of a counterparty default or disruption from geopolitical events, having a single agreement that applies close-out netting across SFTs and derivatives can enable a quicker, more efficient and more consistent approach to managing counterparty risk.

Finally, by using a single ISDA Master Agreement, the ISDA SFT documents simplify and streamline the negotiation and management of SFT and derivatives documentation. Historically, there could be a number of bespoke transactions involving the use of SFTs and derivatives. Reducing the number of legal contracts from as many as three master netting agreements to one can further reduce legal costs and the time it takes to negotiate contracts. Using a single ISDA Master Agreement applies common terms to each transaction, regardless of the product type, which can reduce the potential for basis risk.

Illustrative Use Case for Net Settlement Across Products

Table 1 summarizes the legal economic exposure between two counterparties with securities lending and derivatives transactions, executed with and without ISDA's SFT documentation. The table summarizes the total derivatives and related collateral exposure, followed by securities lending transactions.

To demonstrate the benefit of the ISDA SFT documentation, one scenario assumes the derivative and related cash margin/collateral are under one legally enforceable master netting agreement and the stock borrow and related cash collateral are separately documented under another master netting agreement (ie, no ISDA SFT documentation), and another scenario assumes all transactions are entered into under ISDA's SFT documentation.

Introducing a right of offset process in the event of default or bankruptcy may reduce exposure at default (EAD), reducing the need to double collateral and freeing up resources that are needed to strengthen liquidity. The excess collateral in the SFTs will be used to offset the derivatives' current exposure and vice versa. Upon settlement in the event of default, the exposures under existing agreements versus the ISDA SFT documentation are illustrated below.

Table 1: Comparison of legal economic exposure, with and without ISDA SFT documentation

	Legal economic exposure (No ISDA SFT documentation)	Legal economic exposure (ISDA SFT documentation)
Derivative		
Derivative payable	(1,500)	(1,500)
Collateral receivable	1,000	1,000
Legal economic exposure from derivative and related cash margin/collateral	(500) payment owed	(500) payment owed
Stock borrow and related cash collateral		
Receivable under securities lending agreement (from customer)	100	100
Obligation to return security (to customer)	(75)	(75)
Legal economic exposure from stock borrow and related cash collateral	25 payment due	25 payment due
Total legal economic exposure at default	(500) payment owed 25 payment due	(475) payment owed
Benefit/reduction in cash collateral	No benefit	25 (netting 500 collateral sent and 25 received)

This shows that when derivatives and securities lending transactions are documented separately, the legal economic exposure and EAD is $25 due and $500 owed. Conversely, when using the ISDA SFT documentation, the legal economic exposure and EAD is a net $475 due. As a result, when using the ISDA SFT documentation, preparers still need to carefully consider the accounting literature to determine if it allows for a net $475 due to be shown on the face of the financial statements to align with the legal economic exposure.

The next section of the paper sets out, for the benefit of preparers and users of financial statements, the key issues for achieving net balance sheet treatment based on the existing accounting literature.

EXISTING ACCOUNTING MODELS: US GAAP

General Netting Requirements

Under US GAAP, a fundamental concept of netting assets and liabilities was established by the Accounting Principles Board (APB), which was later replaced by the Financial Accounting Standards Board (FASB). According to APB Opinion 10, paragraph 7, it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper, except where a right of set off exists.

FASB Interpretation 39 (FIN 39) was subsequently issued to further clarify paragraph 7 of APB Opinion No. 10, which is now codified in Accounting Standard Codification (ASC) 210-20-45-1. The FASB clarified the general requirements for offsetting assets and liabilities.

The FASB stated: "A right of set off is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

a) Each of two parties owes the other determinable amounts.

b) The reporting party has the right to set off the amount owed with the amount owed by the other party.

c) The reporting party intends to set off.

d) The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount."

Netting Derivatives Assets and Liabilities

Within FIN 39, the FASB also clarifies the applicability to derivatives instruments. The interpretation indicates that the intention to set off is assumed with regard to (c) above, and an entity may offset fair value amounts of derivatives instruments and fair value amounts of the right to reclaim or obligation to pay cash collateral arising from derivatives recognized at fair value and executed with the same counterparty under a master netting agreement.

A master netting arrangement exists if the reporting entity has multiple derivatives contracts with a single counterparty that are subject to a contractual agreement that provides for the right to set off all contracts through a single payment in a single currency in the event of default on or termination of any one contract. This guidance is specific to derivatives and does not allow for netting across derivatives and other financial instruments.

Netting Receivables and Payables under Repurchase Transactions

Subsequent to the publication of FIN 39, the FASB issued Interpretation 41 (FIN 41), intended to clarify when payables and receivables under repurchase and reverse repurchase agreements may be offset on the statement of financial positions, which is now codified in ASC 210-20-45-11. Similar to FIN 39, the intention to set off under (c) could be disregarded when the agreements were entered into with the same counterparty under a master netting agreement, and have certain required settlement provisions, as summarized in the appendix.

Ability to Achieve Net Presentation

While most of the US GAAP general netting guidance can be met using a master netting agreement, one of the main hurdles in achieving balance sheet netting under US GAAP's general netting guidance is the ability to demonstrate whether an intention to set off exists.

Under US GAAP, balance sheet netting can only be achieved if the following criteria apply:

1. Both parties owe the other determinable amounts – generally met;
2. The reporting party has the right to set off the amount owed with the amount owed by the other party – generally met;
3. The right of set off is enforceable by law – generally met;
4. The reporting party intends to set off – depends on circumstances, but generally not met.

SFTs and derivatives may have different transaction mechanics, timings of settlement and separate legal agreements, which may call into question an entity's intentions. For example, securities lending agreements are commonly documented as open-ended transactions without a set maturity date. SFT agreements and derivatives agreements are each subject to their own netting requirements. As a result, in order to achieve net presentation under US GAAP, entities need to look to the general netting guidance under ASC 210.

As described above, general netting guidance is not typically met for different product types. ISDA's SFT documents allow entities to execute various types of transactions under a single master netting agreement and meet the general netting criteria related to legal rights. However, the intention to set off could still be called into question due to the structure of the transactions, cash flows settling through different systems for each type of product, and historical practice preventing net treatment on the balance sheet.

In limited circumstances, these criteria could be met for certain legs of the transaction, but in practice, it is generally rare for them to be met across products and only achieved in highly structured transactions. For example, in a securities lending transaction, the receivables under the securities lending agreement with the customer, paid in cash, are eligible to be offset against the payable or obligation to return the security to the customer, assuming there is a legally enforceable right of set off, the entity has a history of settling such transactions on a net basis in the normal course that would prove intention to set off and the transaction is settled net.

In addition, as noted above, ASC 210-20-45-11 and ASC 815-10-45 provide specific guidance for repurchase transactions and derivatives, respectively, when the transactions are executed under a master netting agreement, without regard to the condition that requires the intention to set off.

However, the guidance is product specific and does not allow entities to set off balances across different product types. Further, the guidance under US GAAP only relieves companies of the requirement to demonstrate the intent to offset for repurchase agreements and derivatives.

Cross-product netting agreements will help to establish a legally enforceable right to set off across multiple products, but under the current product-specific framework, balance sheet netting will only be met when entities can demonstrate their intention and will typically continue to only net within similar products (eg, consideration of application of netting separately for derivatives and repos). Further, if net treatment is achieved, new reporting considerations may need to be addressed, as outlined later in this paper.

EXISTING ACCOUNTING MODELS: IFRS

Under IFRS, International Accounting Standard (IAS) 32 provides the basis for determining whether financial assets and liabilities can be set off on the balance sheet. The two key requirements are that there is a legally enforceable right to set off the recognized amounts and the entity intends either to settle on a net basis or to realize the asset and settle the liability simultaneously. Net presentation is required if these two conditions are met.

IAS 32 was subsequently revised, which provided further guidance on what is meant by a legally enforceable right and an entity's intention. To have a legally enforceable right, the right to set off must not have any contingencies and must be enforceable in all circumstances, including normal course of business, default or bankruptcy.

IAS 32 was later revised again to clarify the application guidance of the criterion that an entity has a legally enforceable right to set off the recognized amount and the criterion that an entity intends to settle on a net basis or to realize an asset and settle a liability simultaneously. This resulted in additional application guidance to encourage consistent application.

Ability to Achieve Net Presentation

According to IAS 32, paragraph 47, an entity's intentions with respect to the settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of financial markets and other circumstances that may limit the ability to net settle or to settle simultaneously.

Historically, SFTs and derivatives have not been entered into with the intention to settle on a net basis or to realize the asset and settle the liability simultaneously. While the ISDA SFT documentation under a single master netting agreement will create a right of set off, it only becomes enforceable and affects the realization or settlement of individual financial assets and liabilities following a specified event of default or in other circumstances not expected to arise in the normal course of business.

A master netting agreement does not provide a basis for offsetting as it is contingent on a future event and not in the normal course of business. As such, under the existing IFRS accounting rules, an entity is very rarely able to achieve balance sheet netting under a cross-product netting arrangement if it intends to settle on a net basis or to realize an asset and liability simultaneously. The ability to prove intent across products is an even greater challenge because it is generally not operationally possible.

Balance Sheet Presentation

Another question that arises under both US GAAP and IFRS, even if all of the netting criteria are met for different products under the ISDA SFT documents, is how an entity presents the net transaction balance on the balance sheet. Derivatives and SFTs do not generally meet all of the criteria to be presented on a net basis on the balance sheet, but in the event they do, or in the event the accounting standards are changed or amended to allow netting across products, whether that balance is presented as a derivative or as an SFT transaction under US GAAP or IFRS is not currently contemplated.

There is also no guidance on the appropriate measurement methodology to apply when netting across instruments that have different measurement methods (eg, amortized cost and fair value). Under IFRS, there are requirements to disclose amounts related to financial instruments subject to a master netting agreement, even if they are not set off on the balance sheet. Entities will need to consider the measurement methodologies when making these disclosures as well. Without prescriptive guidance on the presentation and measurement methodology, diversity in practice could develop between the financial statements of similar entities with similar transactions.

POSSIBLE FUTURE USE CASES FOR ISDA SFT DOCUMENTATION

While there are near-term use cases for the ISDA SFT documentation as already described in this paper, particularly from a risk management perspective, the structure of the ISDA Master Agreement will allow for further development and standardization as the market becomes more accustomed to cross-product netting.

Use of ISDA's SFT documentation may have consequences across accounting, legal, collateral and operational functions that need to be assessed and considered. The accounting, risk management and collateral management view of these transactions as one netting set, rather than two or more separate netting sets, will affect the available resources of a bank.

As the settlement and operational processes are further aligned for derivatives and SFTs, the economics and the way these transactions are risk managed raises the question of whether the netting criteria under the applicable accounting standards should also be aligned for the purposes of balance sheet presentation, as well as whether regulatory capital requirements should be revised.

Potential Benefits of Future Use Cases: Financial Reporting and Capital

The previous section explored existing US GAAP and IFRS guidance, when and how balance sheet netting may be achieved and the additional issues introduced by cross-product netting.

Considering the example of the legal and economic exposure with and without the ISDA SFT documentation, the accounting presentation is not aligned with the economics of transactions entered into under a cross-product netting agreement. As described above, cross-product netting cannot be achieved under US GAAP because there is no intention to settle on a net basis. Despite there being a legal contract that allows for net settlement in the event of default, operationally companies would not have a single net payment upon settlement.

Additionally, FIN 39 and FIN 41, which eliminate the requirement for companies to prove intent, are product-specific (eg, derivatives only or repurchase agreements only). Similarly, under IFRS, companies cannot demonstrate their intention to settle on a net basis in all circumstances because, operationally, the transactions are settled on a gross basis.

By presenting these transactions on a gross basis, it would appear the entity faces a greater amount of credit risk and risk of loss in future cash flows associated with the assets resulting from the securities lending arrangement. In reality, under the ISDA SFT documentation, the entity would only face the risks and future cash flows associated with the net exposure.

As previously noted, net treatment cannot generally be achieved under either US GAAP or IFRS, and instead only netting across similar products (eg, derivatives or repos) can generally be achieved. However, as the market continues to evolve and the ISDA SFT documents become more prevalent, further consideration of the existing accounting framework may arise.

As the ISDA Master Agreement allows for economic exposure netting of derivatives and SFTs, there is an opportunity for the Basel Committee on Banking Supervision to consider the combined exposure in the capital framework. The right to set off in default should provide regulators with an incentive to change the requirements to recognize these offsets. The possible capital impact, including the potential for more cross-product netting in capital calculations, may be an area for further consideration in future.

Potential Benefits of Future Use Cases: Collateral Optimization

In addition to the potential financial reporting and capital benefits of the ISDA SFT documentation, ISDA is working to promote greater standardization and automation of collateral management processes to increase efficiency and reduce costs. A more efficient, automated collateral management framework will enable firms to better manage their capital and liquidity across products and trading relationships – something that has been prioritized following recent liquidity shocks[2].

Optimization of daily net settlement of collateral across products would support capital, liquidity and collateral management requirements and it could also help to support efforts to set off amounts under SFTs and derivatives in the normal course of business. This would allow entities to create greater efficiency and align risk management with financial reporting practices.

If both derivatives and SFTs are moved from the standard master agreements approach to a single master agreement with cross-product netting, the collateral will need to be reallocated between the transactions. This represents a potential opportunity to optimize collateral and avoid cases of over-collateralization in which collateral is posted for both derivatives and repo portfolios when it only legally has to be posted for the net exposure.

Recent market volatility has highlighted the need for greater stability, predictability and resilience. These factors are leading financial market participants to seek greater efficiency and optimization, which are reflected in the growing demand to access safe and secure liquidity pools, enabling efficient collateral transformation.

Market participants could potentially reduce the need to post collateral for each of their transactions as they are legally required to post the net position across all transactions, which aligns with the economic position and the way these transactions are risk managed. Banks need to gain access to collateral in a way that increases their resource requirements and there is therefore a need to recognize that ISDA's SFT documentation may also potentially reduce settlement risk.

Settlement netting decreases settlement and liquidity risk by reducing the gross physical settlement of securities and cash compared with the traditional standalone situations (see example use case above). Under a cross-product netting agreement, there should be connectivity between all products and the ability to post collateral jointly, which will allow entities to further optimize their use of assets.

Potential Benefits of Future Use Cases: Operational Efficiency

Aside from the benefits of net exposure and settlement for counterparty risk management and potentially also capital benefits, the ISDA SFT documentation also creates an opportunity to reduce operational risks and costs. From an operational perspective, market participants will be able to find synergies in managing derivatives, SFTs and the associated collateral, which are all subject to a single master netting agreement.

There will also be future opportunities to reduce operational costs through further automation and streamlined processing, which can be introduced through the use of standardized terms across various products. Additionally, upon termination, there will be fewer netting sets to consider, further simplifying the close-out process and reducing operational risk.

[2] ISDA Quarterly, Under Scrutiny, April 2023, www.isda.org/a/8zJgE/Under-Scrutiny-IQ-April-2023.pdf

The optimization of collateral is a priority for entities as it will reduce costs and potentially capital usage throughout the trade lifecycle. A similar documentation structure for SFTs and derivatives should make it possible to develop technology on a cross-market basis. By developing technology for all three products and extending any existing technology across these markets, participants can create single solutions to issues affecting both SFTs and derivatives and further leverage the economies of scale that technology has to offer.

In the future, this issue could potentially be overcome through use of the blockchain. Today, there are 'asset-referencing' digital assets that reference an underlying asset through a legal or operational mechanism. Asset-referencing digital assets could be used as a mechanism to track the legal rights and protocols associated with the settlement and close out of different types of SFTs and derivatives entered into under a single master netting agreement on the blockchain.

ISDA's commitment to safe and efficient derivatives markets focuses both on business-as-usual and market stress situations[3]. Among other initiatives, ISDA is actively working with market participants to improve standardization and end-to-end automation in collateral management processes as there are still manual processes required today for many market participants. In normal market conditions, such manual processes may be reliable, but in times of economic stress and volatility, margin and collateral requirements become an operational burden.

More closely aligned contractual provisions for SFTs and derivatives and continued advances in technology will further facilitate the use of cross-product netting, reducing costs and operational burdens. Technology advances will also alleviate the challenges outlined in this paper regarding the ongoing management of transactions, potentially aligning legal with risk, capital and accounting for the transactions subject to cross-product netting and the legal rights and obligations associated with each transaction.

[3] Responding to Market Stress, ISDA, April 24, 2023, www.isda.org/2023/04/24/responding-to-market-stress

CONCLUSION

This paper presents the accounting and financial reporting implications under existing accounting models associated with the netting of SFTs and derivatives under US GAAP and IFRS. It also highlights other risk management, regulatory reporting and capital implications.

With an increase in arrangements that use a single master agreement for simplification of negotiation and management of transactions, the paper explores the accounting criteria that entities need to meet to achieve net presentation and the challenges under current standards.

The paper also presents the benefits that cross-product netting currently provides and highlights the future use cases as the cross-product netting contractual framework continues to evolve.

APPENDIX: SUMMARY OF EXISTING ACCOUNTING REQUIREMENTS

US GAAP requirements			IFRS requirements
General netting	**Repurchase agreements**	**Derivatives**	**General netting**
A right of set off exists when these conditions are met: 1. Each of the two parties owes the other determinable amounts; 2. The reporting party has the right to set off the amount owed with the amount owed by the other party; 3. The reporting party intends to set off; 4. The right of set off is enforceable in law.	An entity may offset payables and receivables recognized under repurchase and reverse repurchase agreements accounted for as collateralized borrowings if these conditions are met: 1. Both agreements are executed with the same counterparty; 2. Both agreements have the same settlement date specified at inception; 3. Both agreements are executed in accordance with a master netting agreement; 4. The securities in both agreements exist in book entry form and can be transferred only by entries in the records of the transfer system operator or securities custodian; 5. Both agreements will be settled on a securities transfer system and the entity has the appropriate associated banking arrangements in place; 6. The entity intends to use the same financial institution account to transact the inflows and outflows at the settlement date. Net receivables resulting from this application will not be offset against net payables.	When a contract is executed with the same counterparty under a master netting arrangement, an entity may offset: 1. Fair value amounts recognized for derivatives; 2. Fair value receivables arising from derivatives; 3. Fair value payables arising from derivatives; 4. Fair value of an accrual component for the periodic unconditional receivables and payables resulting from a contract. An entity will not offset fair value amounts recognized for derivatives without offsetting receivables and payables arising from them, unless the receivables and payables either: 1. Are not fair value amounts; or 2. Arose from instruments that are not eligible to be offset.	A financial asset and liability will be offset and presented net when an entity: 1. Has a legally enforceable right to set off the recognized amounts; 2. Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously. A master netting arrangement usually creates a right of set off unless both of the criteria above are not met. Offsetting is inappropriate when: 1. Several financial instruments are used to emulate the features of a single one; 2. Financial assets and liabilities arise from instruments having the same primary risk exposure but with different counterparties; 3. Assets are pledged as collateral for non-recourse financial liabilities; 4. Financial assets are set aside in a trust to discharge an obligation without being accepted by the creditor; 5. Obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party.

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