

Staff Paper

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Project **Offsetting of financial assets and liabilities**

Topic **Unconditional right and intention to offset**

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## Background

1. At the September 2010 meeting, the boards discussed whether and when offsetting of financial assets and liabilities is appropriate or provide useful information. The Boards concluded that the following factors may be helpful in determining when offsetting provides useful information on the face of the statement of financial position or in the notes:
  - (a) whether the parties need to have the ability to offset or settle net
  - (b) whether the parties need to demonstrate an intent to settle net
  - (c) whether the amounts owed under the respective contracts ought to be settled on the same date or be settled simultaneously
  - (d) whether the financial asset and liability ought to have the same maturity
  - (e) whether the financial asset and liability ought to have the same underlying risk
  - (f) whether offsetting should be on the basis of bilateral or multilateral netting arrangements.
  
2. At the October 2010 meeting the Boards discussed:
  - (a) description of each of the factors mentioned in paragraph 1;
  - (b) possible interactions among those factors; and
  - (c) a framework for analysing the usefulness of offsetting.
  
3. The Boards indicated that an entity should be able to offset a recognised financial asset and liability if the entity has an unconditional right of offset and intends to

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settle net. The Boards also decided to consider whether there are any other circumstances under which it may be appropriate to offset.

**Purpose of this Paper**

4. This paper asks for the Boards decision on:
  - a. whether an unconditional right and intention to offset should form the primary basis for offset under any offset model that may be developed in this project;
  - b. whether the right of offset (unconditional right of offset) should be enforceable in the normal course of business or it should be enforceable both in the normal course of business and in the default or bankruptcy of a counterparty; and
  - c. whether offsetting should be permitted or required if an entity meets the criteria for offset.

**A right and intention to offset**

5. Under today's requirements (both IFRS and US GAAP), an entity can or is required to offset a recognised financial asset and financial liability if the entity has a legally enforceable (unconditional) right to set off and intends to set off those positions<sup>1</sup>.
6. At the October 2010 meeting, the Boards indicated that an entity can offset a financial asset and liability, if the entity has both an unconditional right of offset and an intention to offset.
7. The staff notes that if an entity has an unconditional right of offset and an intention to offset, offsetting reflects:
  - a. an entity's expected future cash flows from settling two or more separate financial instruments; and
  - b. the liquidity and credit risks faced by the entity.
8. Moreover, the approach set out in paragraph 6 is already required (or permitted) under both IFRS and US GAAP, and that based on feedback from preparers, users

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<sup>1</sup> US GAAP also permits offset, in some circumstances, if the entity has a conditional right to offset.

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and auditors does not raise application difficulties in practice. That approach is consistent with the Boards joint *Framework* and provides useful information to users of the financial statements.

9. The staff therefore recommends that the Boards confirm that an unconditional right and intention to offset should form the primary basis for offset under any model of offset that may be developed in this project.

**Question for the boards**

Do the Boards agree with the staff conclusions and recommendation in paragraph 9? If not, why not?

**Should an unconditional right of offset be enforceable both in the normal course of business and in bankruptcy of a counterparty**

10. Under law, offset arises when the amounts due from the several contracts, which may involve obligations to pay under one contract and a right to receive under another, are summed together and the several obligations to pay or be paid are combined into a single obligation for the net amount.<sup>2</sup>
11. Current guidance under US GAAP and IFRS on enforceability of an unconditional right are as follows:
  - a. US GAAP<sup>3</sup> – states that “A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.” It further explains that – “The right of setoff is enforceable at law.” (Note: The phrase *enforceable at law* encompasses the idea that the right of setoff should be upheld in bankruptcy.).
  - b. IFRS – requires that - “an entity currently has a legally enforceable right to set off”.
12. Hence, some argue that under IFRS the right of offset (unconditional right of offset) should be enforceable in the normal course of business (currently enforceable)

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<sup>2</sup> *Goode, R.*, Legal problems of credit and security, Third edition, Sweet & Maxwell, London (2003)

<sup>3</sup> ASC 210-20-45-1, 45-2, and 45-9

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whereas US GAAP requires the right of offset to be enforceable both in the normal course of business and in the default or bankruptcy of the counterparty.

13. The staff notes that set off may, generally, be available both outside and within bankruptcy.
14. Except in bankruptcy or any such event, the limits on contractual set-off are for the most part practical rather than legal. Generally, parties to a contract are free to agree on almost any terms for set-off of their liking and these will be effective so long as they are not displaced by bankruptcy. Most countries allow contractual set-off or netting prior to bankruptcy of a party.
15. On bankruptcy, however, the bankruptcy rules become mandatory; displacing all other forms of set-off not exercised prior to bankruptcy. This is of no significance in relation to transaction set-off (set off at common law or in equity), as in virtually every situation in which that form of set-off is available there would be an automatic set-off under the rules of insolvency.
16. There is however questions as to whether or not on bankruptcy of a contractual party the non defaulting party will be permitted to exercise any contractual right to net all obligations owed under the agreement.
17. One of the important considerations is cross-border differences because different countries have different legal environments and local laws in some countries may not recognise some contractual set-off provisions in bankruptcy of one of the parties. Some countries are known to be debtor-friendly while others are creditor-friendly with respect to set-off on insolvency.
18. In some jurisdictions, contractual bilateral set-off arrangements would survive in bankruptcy of the counterparty. In those jurisdictions, set-off is treated as having taken place automatically on the bankruptcy date. The original claims are thus extinguished and only the net balance remains owing one way or the other. The creditor is thus exposed to insolvency risk only for the net balance<sup>4</sup>.

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<sup>4</sup> Re BCCI (No.8) and Stein v Blake [1996]

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19. Many jurisdictions have developed protective statutes ('carve-outs') which allow for set-off and netting only in financial markets and or obligations and claims arising from clearing or payment systems. The carve-outs, however, protect only some types of financial contracts or only contracts between particular counterparties or only if the contract is a specified market contract or the clearing or payment system meets specified criteria. Where the criteria are met, the carve-out legislation will preserve the validity of netting arrangements in insolvency and provides that any netting arrangement operate according to their terms even within insolvency.
20. The staff believes that the most significant concern is with payment netting provisions in agreements such as the ISDA Master Agreement.
21. Under payment netting provisions (in master netting agreements and similar arrangements), both contracting parties undertake to accept the net performance of the other party. It may apply only to amounts or deliveries due on the same date and only if the payments are in the same currency or are the same asset. This provision ensures **automatic offset** of each party's obligation to make payments (automatic satisfaction and discharge) and replacement with an obligation to make payment or a right to receive payment of the net sum. This provision may be applied to cash flows resulting from multiple transactions where payments occur on the same date and in the same currency, if parties so elect in the schedule or in the confirmation.
22. The ISDA Master Agreement, however, imposes a conditions precedent on the payment obligations of each of the parties, in particular, that no actual or potential event of default, has occurred and is continuing with respect to the other party, and that nothing has occurred which has led to action being taken to achieve an early termination of the outstanding transactions under the agreement.
23. In effect, the payment obligations of the non-defaulting party are suspended where the condition concerns an event of default relating to the other party. On the other hand the payment obligations of both parties are suspended if the termination procedures have been commenced. This condition precedent is set out in section 2(a)(iii) of the Master Agreement.

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24. The Master Agreement allows the non-defaulting party to treat the insolvency event as an event of default and gives it the right, but not the obligation, to terminate all transactions under the agreement. Although technically there is no suspension of payments due to section 2(a)(iii) the payment obligations do not arise because the condition precedent is not fulfilled.
25. Hence in some jurisdictions and under some governing contract laws, payment netting provisions in contractual agreements such as the ISDA master netting agreement may not be enforceable in all circumstances. However, the combination of a payment and close out netting provisions in one agreement may allow for offset in all circumstances (although close-out netting is a conditional right). Hence it can be argued that netting on the basis of payment netting provisions can be enforced in all scenarios (depending on the jurisdiction).
26. Some argue that the existence of an unconditional enforceable right to set-off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and liability and affect an entity's exposure to credit and liquidity risk. They also argue that, in the absence of an unconditional right of offset that is enforceable in all scenarios, the rights and obligations underlying each individual financial asset and liability are not altered and hence such instruments should not be presented net.
27. The staff believes that an unconditional right of offset should be enforceable in all circumstances (both in normal course of business and in bankruptcy) for the relevant positions to be offset.
28. The staff therefore recommends that the Board defines unconditional to mean a right of offset that is enforceable in all circumstances (including bankruptcy of a counterparty).

**Question for the boards**

Do the Boards agree with the staff conclusions and recommendation in paragraph 28? If not, why not?

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**Should offset be required or permitted if the offset criteria is met**

29. When the offsetting criteria are met, IFRS requires entities to offset financial assets and financial liabilities while U.S. GAAP permits, but does not require, offsetting when the specified criteria are met.
30. As noted in the staff summary of user feedback on offsetting (see Agenda Paper 8C – September 2010 meeting), although there was no overall consensus regarding the appropriateness of providing gross versus net information on the face of the statement of financial position, users were unanimous in their preference for a common solution. Users argued for a high-quality, converged standard to be developed to allow for international comparability, especially among banks. The staff understanding is that, a common solution (and hence consistent approach and application of that guidance) will enhance comparability of different entities.
31. The staff notes that financial statements provide useful information if it enables users to identify similarities in and differences between entities and across time. The staff notes that information about an entity is more useful if it can be compared with similar information about other entities. Thus the staff recommends that the Boards should require offset if the offset criteria is met to avoid diversity which may result if this is made an accounting policy choice.
32. This issue is relevant irrespective of the basis of offset or the offset criteria that the Boards may adopt. Hence, should the Boards agree with the staff recommendation, the same requirement will be applicable whether offsetting is based on unconditional or conditional rights of offset.

**Question for the boards**

Do the Boards agree with the staff conclusions and recommendation in paragraph 31? If not, why not?

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