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für Rückfragen zu der beigefügten Publikation „In depth“ zur Thematik „Offsetting financial instruments for financial institutions“ stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

Guido Fladt
Tel.: +49 69 9585-1455
E-Mail: g.fladt@de.pwc.com

Wolfgang Weigel
Tel.: +49 69 9585-2574
E-Mail: wolfgang.weigel@de.pwc.com

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What's inside:

Offsetting financial instruments for financial institutions

At a glance

The IAS 32 offsetting amendment, as well as regulatory changes impacting a number of jurisdictions, has prompted many financial institutions to reassess when they offset financial instruments for accounting purposes.

Offsetting is a complex area of accounting, where understanding the operational and contractual arrangements is key to arriving at the right accounting conclusion. The recent reassessments have highlighted the extent of these complexities. This 'In depth' sets out our views on the main questions we are seeing in practice.

Background

The offsetting amendment to IAS 32 is effective for annual periods beginning on or after 1 January 2014. It does not change the requirements for offsetting a financial asset and a financial liability. But it does provide further guidance intended to address inconsistencies identified in application.

However, the amendment has prompted many financial institutions to reassess when they offset financial instruments more widely, not solely those aspects directly affected by the amendment. For some financial institutions, this reassessment has also been prompted by an increased focus on balance sheets that is driven by regulatory pressures as well as other regulatory-driven changes affecting contracts involving central clearers and exchanges.

This paper discusses frequently asked questions that have arisen in relation to the IAS 32 offsetting amendment, as well as offsetting more generally.

Applying the offsetting requirements of IAS 32 can be complex. Understanding the underlying operational and contractual arrangements is often the greatest challenge, so care should be taken to ensure the accuracy of this understanding before then forming accounting conclusions. Accounting conclusions might also vary between different countries due to the different legal frameworks.

Given this complexity and the wide range of possible scenarios, the views set out in this paper only represent current thinking based on the examples seen to-date. In addition to accounting conclusions, this paper includes comments on 'What we are seeing in practice', highlighting common practical application issues that often need further discussion.

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Summary of questions

The questions discussed in this publication are set out below, along with the major types of financial instrument to which they will typically be relevant.

		Typically relevant to:			
#	*Question*	*OTC derivatives*	*Listed derivatives*	*Repos*	*Futures*
A. Balances that should be considered for offsetting					
1	Which financial instrument balances should be considered for the purposes of offsetting?	X	X	X	X
2	Does daily posting of cash margin result in daily extinguishment through legal settlement of the contract, leaving no recognised cash collateral balances to be offset?	X	X		X
B. Currently enforceable right to set off					
3	If a clearing house / exchange has a right to change the rules applicable to settlement processes, does this prevent offsetting from being applied?	X	X	X	X
4	Where daily cash settlements contractually have to be made on a net basis for all derivatives with a particular counterparty, is it possible to offset an uncollateralised derivative asset and an uncollateralised derivative liability held with that counterparty?	X	X		
5	Can cash collateral posted in respect of a portfolio of derivatives be offset against the balance sheet derivative positions?	X	X		
6	What impact does the ability to post non-cash collateral (for example, securities) have on offsetting a portfolio of derivatives against collateral?	X	X		
7	What impact does the existence of a physical settlement option have on offsetting a derivative against cash collateral?	X	X		
8	What impact might a 'one way' collateral posting arrangement have on applying offsetting?	X	X		
9	Do financial assets and liabilities that are subject to a legally enforceable arrangement for simultaneous settlement qualify for offsetting?			X	
10	Can repos and reverse repos with different bond CUSIPs/ISINs be offset?			X	
C. Intention either to settle on a net basis or to realise the asset and settle the liability simultaneously					
11	In what circumstances will the IAS 32.42(b) requirement 'to realise the asset and settle the liability simultaneously' be met?			X	
12	What evidence is required to demonstrate an intent to settle net or simultaneously?	X	X	X	X
D. Other considerations					
13	Which accounting periods will be impacted by the offsetting amendments?	X	X	X	X

A. Balances that should be considered for offsetting

1. Which financial instrument balances should be considered for the purposes of offsetting?

Where the offsetting criteria of IAS 32.42 are met, applying offsetting accounting to the relevant financial assets and liabilities is required; it is not merely an option. The two basic requirements of IAS 32.42 are unchanged by the amendment to IAS 32, with offsetting being applied if, and only if, an entity:

- currently has a legally enforceable right to set-off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

However, the amendment to IAS 32 clarifies that a currently legally enforceable right of set-off:

> *"(a) must not be contingent on a future event; and*
> *(b) must be legally enforceable in all of the following circumstances:*
> *(i) the normal course of business;*
> *(ii) the event of default; and*
> *(iii) the event of insolvency or bankruptcy*
>
> *of the entity and all of the counterparties."* (IAS 32R.AG38B)

In many instances, it will be clear with little or no analysis that the offsetting criteria are not met. In other cases, more analysis might be required. Financial instruments where offsetting might be achieved and where analysis is typically required include collateralised over-the-counter (OTC) derivatives, repo and reverse repo transactions, futures and listed derivatives. However, offsetting might be applicable in other situations, such as cash pooling arrangements and where payables and receivables are settled net with the same counterparty.

2. Does daily posting of cash margin result in daily extinguishment through legal settlement of the contract, leaving no recognised cash collateral balances to be offset?

Where cash margin is paid or received on a financial instrument contract, the accounting analysis is typically either:

- Option A: the cash is partial settlement of the outstanding contract; or
- Option B: the cash is payment of collateral, which might have to be repaid, depending on future changes in the value of the trade being collateralised, and should be separately recognised as a collateral asset / liability.

In order for Option A to apply and the cash payment to achieve partial derecognition of the original trade, the derecognition requirements of IAS 39 must be met. This will generally be because, under the terms of the relevant contract(s), the cash payment causes:

- for an asset, the contractual rights to cash flows of the original contract to expire (as they are satisfied in full by the receipt of cash) in accordance with IAS 39.17(a); or
- for a liability, the contractual obligations under the original contract to be discharged in accordance with IAS 39.39.

In order to conclude whether Option A or B is applicable, the specific contractual terms of the trade contract and any other relevant terms (for example, where the contract is traded on an exchange, the exchange's regulations or rules) will need to be considered to determine whether, legally, the original contractual rights and obligations have been partially settled. Where these contractual terms are not explicit, legal advice might be necessary in order to reach a conclusion. Factors relevant to the legal analysis of whether cash margin does result in legal settlement of the original contract might include whether the contract provides for:

- payment of interest (sometimes referred to as 'price alignment interest') calculated in respect of previous margin payments. This indicates that, economically, these previous margin payments are viewed as a loan or deposit that accumulates interest and hence is collateral;
- the amount of margin required to be subject to a valuation 'haircut'. This indicates that the payment is collateral since, if there are no further changes in the value of the trade contract, some of the margin (the 'haircut') will be returned; and
- rights to substitute previous margin payments (that is, to repay cash margin and post securities instead), indicating that the previous cash payments were not utilised to discharge the original contract.

What we are seeing in practice

Futures margin is typically viewed as resulting in settlement, although there are exceptions.

Margin on listed and OTC derivatives is typically not considered settlement.

B. Currently enforceable rights to set off

3. If a clearing house / exchange has a right to change the rules applicable to settlement processes, does this prevent offsetting from being applied?

The amendment to IAS 32 states that the right of set-off "*must not be contingent on a future event*" (AG38B) and explains in BC84 that *"a right of set-off that could disappear or that would no longer be enforceable after a future event that could take place in the normal course of business or in the event of a default, or in the event of insolvency or bankruptcy, such as a ratings downgrade, would not meet the currently legally enforceable criterion..."*.

Therefore, if a clearing house /exchange has a right that is judged to be substantive and which allows it to change the rules in such a way that the right of set-off could disappear or no longer be enforceable, offsetting should not be applied.

This issue was initially raised in respect of Regulation 34 of the LCH.Clearnet Limited ('LCH Limited') rulebook, which allows LCH Limited to unilaterally vary its rules, effective for existing open contracts, such that the legal right to set off could be withdrawn. For this specific situation, it has been concluded that Regulation 34 is not a substantive right that could be used to remove the right of offsetting, due to factors including:

- LCH Limited confirming that they do not currently envisage making any changes to the rulebook with the intention of removing a member's legally enforceable right of set-off;
- oversight by multiple global regulators and the likelihood of their intervention in the event of any such change being proposed, given the impact on systemic credit risk;
- the adverse commercial consequences to LCH Limited of such a change, given the importance of offsetting to their clients; and

- the significant operational changes required by LCH Limited and all its members to settlement processes in the event of any such change.

So, Regulation 34 does not prevent offsetting from being applied to contracts, such as those transacted on the SwapClear or RepoClear platforms, with LCH Limited. For other clearing houses or exchanges with similar powers, the individual facts and circumstances will need to be separately assessed. However, the factors set out above are likely to be relevant in judging whether the powers are substantive and therefore prevent offsetting.

What we are seeing in practice

Our expectation is that similar factors to those listed above are likely to be present for other clauses similar to Regulation 34. If so, these clauses are likely to be judged as non-substantive for the purposes of offsetting. The nature of any rule change clauses is likely to differ between platforms, given the way in which each set of rules has evolved over time. Analysis based on specific facts and circumstances will therefore be required.

4. Where daily cash settlements contractually have to be made on a net basis for all derivatives with a particular counterparty, is it possible to offset an uncollateralised derivative asset and an uncollateralised derivative liability held with that counterparty?

Yes, but only if the two derivatives have matching terms so that all their cash flows will occur on exactly the same dates in all situations. If this is the case, under the daily net settlement process all future cash flows will be required to be settled net, so that the entity has a legal right to offset the derivative asset (that is, all the contracted cash flows) against the liability.

However, in a typical situation the two derivatives are unlikely to have matching terms, and so their cash flows will not all occur on exactly the same dates in all situations. In this case, the entity does not have a legally enforceable right to set off the derivative asset (that is, all the contracted cash flows) against the liability. This can be illustrated by a simple example, where the derivative asset and liability both have one remaining cash flow, which occurs in one month's time for the asset and in two months' time for the liability: the entity does not have the legally enforceable right to set off the recognised derivative asset against the liability, because the cash flows will occur on different dates and will not be net settled under the net settlement process.

5. Can cash collateral posted in respect of a portfolio of derivatives be offset against the balance sheet derivative positions?

As a simple example, an entity might have entered into a single derivative with a bank or clearing house. To reduce credit risk, the two entities might have agreed to post cash collateral periodically with each other equal to the fair value of the derivative. The posting of the collateral does not result in legal settlement of the outstanding balance. However, the terms of the collateral agreement are that the collateral will be used to settle the derivative as and when payments are due (as well as on a default or bankruptcy of either party) and both entities intend to settle this way.

If this is the case, the entity will have a legally enforceable right to set off the derivative and the collateral, and will intend to settle net. If market prices do not change, no further cash flows will arise. Any changes in the collateral balance post balance sheet date arise as a result of future events and are not relevant to the balance sheet date assessment. The offsetting requirements in IAS 32 are therefore met, and the collateral should be offset against the balance sheet derivative position. If, on the other hand, the cash collateral is not used to settle the derivative's remaining cash flows, the offsetting requirements in IAS 32 are not met.

More typically, an entity will have a portfolio of derivatives with a bank or clearing house, rather than just a single derivative. If the net cash collateral required to be posted for the whole portfolio is the aggregate of the individual amounts of cash collateral for each derivative in the portfolio (each individual amount again being equal to the fair value of the derivative), the above analysis for a single derivative should be applied. This is done by firstly dividing the net cash collateral payable or receivable balance into the individual amounts relating to each derivative in the portfolio. For each individual derivative, the derivative balance is then offset against the associated collateral balance in the same way as described in the simple example above. In practice, in the absence of factors such as time delays between derivative fair value movements and cash collateral movements, this should result in the entire derivative portfolio being offset against the cash collateral balance.

What we are seeing in practice

Some institutions are unclear on the basis on which they are offsetting portfolios of derivatives against the associated collateral. Often, they are offsetting derivatives against other derivatives (see question #4) and then offsetting the resulting net derivative balance against collateral. In practice, this might not lead to a difference in the net result compared to the above analysis, but it could risk overlooking other complexities.

In particular, bilateral OTC trades between a bank and an SME are typically not subject to cash collateral netting in the ordinary course of business, with collateral payments made separately from derivative payments. As a result, further cash flows will arise, even if market prices do not move, and so offsetting is not permitted. Even where cash collateral netting is applied in the ordinary course of business, if this just a matter of practice but the contracts between the bank and SME do not give them the contractually enforceable right to do this, the parties are still not permitted to offset.

6. What impact does the ability to post non-cash collateral (for example, securities) have on offsetting a derivative against collateral?

Non-cash collateral received (rather than posted) by an entity will not be recognised on-balance sheet, because it will fail derecognition in the transferor and so provides the entity with no accounting entry against which to offset on-balance sheet derivative positions. Therefore, consider a simple scenario where a firm has one trade that is an asset of 50 and another trade that is a liability of 50; if the liability matures first, cash of 50 will be paid by the firm to settle the liability, and securities of 50 will be received as collateral for the remaining asset trade of 50. As a result, the firm does not have the legally enforceable right to set off the recognised amounts (that is, the asset trade of 50 and the liability trade of 50), and so the requirements for offsetting are not met.

7. What impact does the existence of a physical settlement option have on offsetting a derivative against cash collateral?

In some situations, it is possible that a contract will be settled not by cash being paid but by the delivery of a physical asset. An example is an exchange-traded, cash-collateralised Credit Default Swap (CDS). Ordinarily, the cash collateral paid by an entity to the exchange is used to net settle the CDS liability when a credit event has occurred. However, on a credit event the exchange could settle the contract by retaining the cash collateral already paid by the entity and physically delivering to the entity the defaulted bond that is the reference asset underlying the CDS in return for the entity delivering additional cash equal to the difference between the bond principal and the cash collateral already paid. Exchange-traded commodity contracts are another example of contracts that can feature a physical settlement option.

By virtue of IAS 32.AG38B, the right of set-off must not be contingent on a future event and it must be enforceable in the normal course of business in the event of default and in the event of insolvency or bankruptcy. If the option to physically settle the contract can be imposed by the exchange and cannot be avoided by the entity, and the bond and cash are not settled simultaneously in accordance with IAS 32.AG38F, the entity's ability to set off the cash collateral paid against the CDS liability is contingent on the decision of the exchange and is not legally enforceable in all circumstances, and so fails the requirements of IAS 32.AG38B. If the physical settlement option is solely at the discretion of the entity and not the exchange, this would not by itself prevent the entity from applying offsetting.

In some cases, it might be possible to demonstrate that the return of cash collateral, the delivery of the physical asset and the payment of any other monies required (for example, the exercise price) are settled simultaneously in accordance with IAS 32.AG38F and that offsetting should still be applied. However, this is likely to require very detailed analysis of the different scenarios that could arise and the payment mechanisms that would be used for each.

What we are seeing in practice

Very few institutions have yet considered whether physical settlement options might meet IAS 32.AG38F, and we have yet to see analysis that shows this can achieve offsetting.

8. What impact might a 'one way' collateral posting arrangement have on applying offsetting?

Under a so-called 'one way' collateral arrangement between a firm and an exchange, cash margin is typically only required to be paid if a firm is in a net liability position. If the exchange is in a net liability position, it is not required to pay cash margin to the firm. Consider a simple scenario where a firm has one trade that is an asset of 50, another trade that is a liability of 30, and nil cash margin (because the exchange is in a net liability position); if the liability matures first, the firm will be required to pay 30 to the exchange to settle it. As the firm's remaining position will be the asset of 50, under the 'one way' arrangement the exchange will remain in a net liability position, and so no margin payment will be made to the firm. On this analysis, the liability would not have been offset against the asset – if this had been the case, only a net payment of 20 would have been required. The requirement for an entity to have a legally enforceable right of offset is not therefore met, and so the positions should not be offset.

What we are seeing in practice

In practice, the accounting analysis is likely to be made more complex by the existence of multiple positions with an exchange. Whilst there might be various ways of analysing such a scenario, we have yet to see analysis that shows that offsetting can be achieved in such a situation.

9. Do financial assets and liabilities that are subject to a legally enforceable arrangement for simultaneous settlement qualify for offsetting?

IAS 32.42(a) requires that offsetting be applied when, and only when, an entity currently has *"a legally enforceable right to set off the recognised amounts"*, including in the normal course of business. However, the settlement arrangements for a clearing house / exchange and its members might involve a member having:

- both the right and the obligation to settle transactions in the normal course of business through a gross settlement system that meets the characteristics set out in IAS 32.AG38F (that is, the outcome is in effect equivalent to net settlement);
- the right to actually set off and settle net in the event of the counterparty's default/insolvency/bankruptcy; and
- an obligation to actually set off and settle net in the event of its own default/insolvency/bankruptcy, if the counterparty so elects.

In such a case, the entity does not have a legal right to actual net settlement that is enforceable in the normal course of business.

In our view, the requirement of IAS 32.42(a) to have a legally enforceable right to set off is still met in this scenario. This is supported by IAS 32.45 which explicitly states that: *"A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor"*. In this scenario, the gross amounts are 'eliminated' during the settlement process, and it is irrelevant that such elimination is carried out by exchanging the gross amounts using a clearing system. In this situation, IAS 32.AG38F indicates the types of gross settlement process that have an outcome that is equivalent to net settlement in the normal course of business.

10. Can repos and reverse repos with different bond CUSIPs/ISINs be offset?

When offsetting a sale and repurchase agreement (repo) and a reverse repo under IAS 32, the asset and liability being offset are typically the cash payable on the repo and the cash receivable on the reverse repo, and not the bonds themselves, given that they might not even be on-balance sheet (see question #7). Therefore, offsetting can be applied, provided the terms of the cash payable and receivable meet the IAS 32 offsetting criteria, irrespective of whether the bonds underlying the repo and reverse repo are identical and have the same CUSIP/ISIN.

However, in practice the bonds and cash payments will typically all need to be settled through the same settlement institution (for example, a central securities depository (CSD), such as EuroClear or ClearStream) in order to settle the cash legs on a net basis or to realise them simultaneously in accordance with IAS 32.AG38F. This does therefore mean that the type of bond, and hence the CSD through which it settles, will restrict to some extent the repos and reverse repos that qualify for offset.

C. Intention either to settle on a net basis or to realise the asset and settle the liability simultaneously

11. In what circumstances will the IAS 32.42(b) requirement 'to realise the asset and settle the liability simultaneously' be met?

In some situations, rather than being settled net, an asset might be realised and a liability settled simultaneously in a way that still meets the requirement of IAS 32.42(b). This is often the case for repo and reverse repo transactions. Further guidance is provided in IAS 32.AG38F, which states that *"If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion in paragraph 42(b). This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle."*

In addition to this principle, IAS 32.AG38F provides a set of characteristics based on LCH Repoclear as an example of a gross settlement system that would meet this principle:

> *"(a) financial assets and financial liabilities eligible for set-off are submitted at the same point in time for processing;*
> *(b) once the financial assets and financial liabilities are submitted for processing, the parties are committed to fulfil the settlement obligation;*
> *(c) there is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing (unless the processing fails—see (d) below);*
> *(d) assets and liabilities that are collateralised with securities will be settled on a securities transfer or similar system (for example, delivery versus payment), so that if the transfer of securities fails, the processing of the related receivable or payable for which the securities are collateral will also fail (and vice versa);*
> *(e) any transactions that fail, as outlined in (d), will be re-entered for processing until they are settled;*
> *(f) settlement is carried out through the same settlement institution (for example, a settlement bank, a central bank or a central securities depository); and*

(g) an intraday credit facility is in place that will provide sufficient overdraft amounts to enable the processing of payments at the settlement date for each of the parties, and it is virtually certain that the intraday credit facility will be honoured if called upon."

Whilst these characteristics are not explicit requirements for offsetting under IAS 32R, in practice they provide a helpful basis for assessing whether the principle of IAS 32.AG38F is met. Given the potential differences between settlement processes made using different settlement institutions, a separate analysis might be required for each material method of settlement. A detailed knowledge of all the relevant payment processes is therefore typically needed in order to perform this analysis.

12. What evidence is required to demonstrate an intent to settle net or simultaneously?

The extent of evidence required will depend on the specific facts and circumstances, including the terms of the relevant contracts. Where an entity is contractually required to settle on a net basis, or to realise the asset and settle the liability simultaneously, and (where relevant) the settlement process meets the characteristics set out in IAS 32.AG38F, this alone will be sufficient.

In other situations where there is no such contractual requirement, factors such as broader market practice and the entity's own past practice for similar transactions should be considered, although this will not necessarily be conclusive by itself. If there have been instances where settlement has not been on a net basis or simultaneous in accordance with the criteria of IAS 32.AG38F, these should be assessed in detail.

For bespoke transactions, factors such as the commercial or operational implications of settling net versus gross – or simultaneously versus at different times – should be considered in judging whether or not there is sufficient evidence to demonstrate an intent to settle net or simultaneously.

D. Other considerations

13. Which accounting periods will be impacted by the offsetting amendments?

IAS 32.97L states that the offsetting amendments shall be applied to annual periods beginning on or after 1 January 2014. However, the amendments are required to be applied retrospectively, with restatement of the comparative period as well as related supporting notes and disclosures, including the IFRS 7 offsetting disclosures. Where the effect is material, this will require the presentation of a third statement of financial position as at the beginning of the preceding period in accordance with IAS 1.40A.

To determine the retrospective impact of the amendment, it will be necessary to obtain an understanding of the extent and nature of any contract / settlement rule changes that occurred during the prior periods. In a number of cases, the settlement rules applied by central clearers and exchanges were being amended in late 2013 in order to comply with new regulatory requirements – such as the European Market Infrastructure Regulation (EMIR). Where such rule changes are significant, it might be necessary to perform an analysis of the previous rules to quantify the retrospective impact of the amendment, as well as analysing the new rules for the current period.