

28 April 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

AOSSG comments on IASB Exposure Draft ED/2011/1
Offsetting Financial Assets and Financial Liabilities

The Asian-Oceanian Standard Setters Group (AOSSG) is pleased to provide comments on the Exposure Draft ED/2011/1 *Offsetting Financial Assets and Financial Liabilities* (ED/2011/1). In formulating its views, the AOSSG sought the views of constituents within each jurisdiction.

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Thailand, and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Other views that are consistent or otherwise with the overall AOSSG comments are also provided within this submission. Individual member standard setters may also choose to make separate submissions that are consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold.

This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG's Financial Instruments Working Group. The AOSSG has not received any substantive contrary views from our constituents.

Overall, the AOSSG supports the IASB's proposals to retain the existing IAS 32 *Financial Instruments: Presentation* requirements for offsetting financial assets and financial liabilities on the face of the balance sheet. In our experience, those existing offsetting requirements have been applied in a reasonably consistent manner in the Asian-Oceanian jurisdiction, where such requirements are applied. In addition, most AOSSG members agree with the IASB's rationale for prohibiting netting of collateralised assets and liabilities against their

associated underlying financial assets and financial liabilities. The AOSSG also considers there is no basis for excluding multi-lateral set off arrangements from the scope of offsetting if all the criteria proposed in ED/2011/1 are met.

However, some AOSSG members are concerned about some of the proposed additional guidance, particularly in clarifying the intention of attaining an unconditional right in offsetting financial assets and financial liabilities. These members are also concerned that some of the proposed principles have been embedded in the proposed guidance and should be included in the principles of the final Standard for clearer application of the offsetting requirements.

In addition, some AOSSG members consider there is an inconsistency in the proposed application guidance relating to simultaneous settlement 'at the same moment' and would like the guidance in the final Standard to be described more clearly.

Whilst the AOSSG is supportive of more robust disclosures about financial assets and financial liabilities that offset on the face of the balance sheet, and some AOSSG members support the specific ED/2011/1 disclosure proposals, most AOSSG members are concerned about the cost burden and relative usefulness of those disclosures. Most AOSSG members believe there is a need for them to be re-considered in conjunction with proposed disclosures in other financial instruments exposure drafts and in IFRS 7 *Financial Instruments: Disclosures* as a whole. Those AOSSG members consider there is an opportunity to have a more cohesive and cost-effective set of disclosure requirements.

The AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the IASB finds our comments helpful in progressing the replacement of existing standard.

The AOSSG views, as summarised above, are explained in more detail in the attached Appendix. At the end of the letter, we also attach the separate comments on certain Islamic finance impacts of the proposals in the ED from the Islamic Finance Working Group of the AOSSG.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely



Ikuo Nishikawa
Chairman of the AOSSG



Kevin M. Stevenson
Leader of the AOSSG Financial Instruments
Working Group

Appendix**1 Principles for offsetting criteria (Questions 1 and 2)**

- 1.1 The AOSSG is supportive of the IASB's proposal to retain the existing IAS 32 *Financial Instruments: Presentation* requirements for offsetting financial assets and financial liabilities on the face of the balance sheet.

Unconditional and legally enforceable right to offset

- 1.2 While the proposed offsetting criteria in ED/2011/1 is not expected to change the outcomes under IAS 32, the AOSSG notes that ED/2011/1 clarifies that the right to offset must also be 'unconditional'. Paragraphs C5 and C6 of ED/2011/1 further clarify that aside from a contract, a right of set off may also arise as a result of a provision in law (or a regulation).
- 1.3 Most AOSSG members note the application of 'unconditional' in ED/2011/1 in comparison to other Standards, for example, paragraph 69(d) of IAS 1 *Presentation of Financial Statements*, which states that "an entity shall classify a liability as current when... it does not have an 'unconditional' right to defer settlement of the liability for at least twelve months after the reporting period...". In particular, these members are aware that in practice the 'unconditional' criterion in paragraph 69(d) of IAS 1 is applied in a going concern context. The IASB's proposed clarification of the meaning of unconditional in ED/2011/1, which includes assessing conditionality in the context of bankruptcy or insolvency calls into question how that term should be interpreted in other IFRSs. These members are of the view that if the 'unconditional' requirement were applied in the proposed context under IAS 1, all liabilities would most likely be classified as 'current'. Accordingly, these members consider the IASB should clarify its intention in proposing the guidance relating to 'unconditional right', and how that relates to other Standards with a similar notion.
- 1.4 In addition, those AOSSG members consider that if the proposed requirement for a right to set off to be unconditional and legally enforceable in all circumstances, including at times of bankruptcy or insolvency, is included in IFRS 9 *Financial Instruments*, this notion should be incorporated in the principles of the Standard and not in the guidance.
- 1.5 Some AOSSG members also consider that the requirement for reassessment of the right of set off when conditions have changed should be incorporated in the principles of the Standard and not in the guidance.

Settlement on a net basis or simultaneously

- 1.6 Some AOSSG members note that paragraph C12 suggests that it may be possible for the operation of a clearing house not to fulfill the "simultaneous settlement" criterion. This appears to be inconsistent with C9 of ED/2011/1 and paragraph 48 of IAS 32, whereby simultaneous settlement is deemed to occur through the operation of a clearing house.
- 1.7 Due to the way in which ED/2011/1 is written, these members consider ED/2011/1 unclear as to whether entities would be required to demonstrate the fulfilment of simultaneous settlement for every settlement transaction with the clearing house, and consider such a requirement to be burdensome to entities in situations where processing constraints may

cause insignificant delays in settlement. These members urge the IASB to clarify the intention of this criterion and the proposed guidance to avoid diversity in interpretation and application.

Offsetting of cash collateral against underlying derivative financial instruments

- 1.8 ED/2011/1 states that an entity shall not offset financial assets, including cash, pledged as collateral or the obligation to return collateral and the associated financial assets and financial liabilities. Some members consider that this proposal would impact the treatment of cash margin accounts related to derivative contracts, for example, over the counter transactions. Under the proposals, such margin accounts are described as a form of collateral for the counterparty or clearing house. However, these members consider that, in effect, 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. Other members also understand that implication is that offsetting of derivatives and cash collateral can be achieved in some circumstances under IAS 32. Accordingly, these members consider there is a need for a clear basis as to why offsetting is prohibited on cash margin arrangements.
- 1.9 Most other members consider that, in addition to the reasoning in paragraphs BC62 and BC63 of ED/2011/1, the right to collateral assets is conditional to a future event, and as such, these members are supportive of the proposal to prohibit offsetting of collateral assets and liabilities, and its associated financial assets and financial liabilities.

2 Multi-lateral set off arrangements (Question 3)

- 2.1 The AOSSG supports the IASB's conclusion that, although multi-lateral offsetting is likely to be unusual, there is no basis for explicitly excluding multi-lateral set off arrangements from the scope of offsetting if all the criteria proposed in paragraph 6 of ED/2011/1 are met.

3 Cost burden versus user benefit disclosures (Question 4)

- 3.1 While some AOSSG members do not believe there is a need to provide gross to net reconciliations by class of financial instruments [paragraphs 12(a) and 12(b)], most members are supportive of such disclosures. These members consider disaggregation of information, especially those that make up the net amounts of rights and obligations, to be useful to some groups of users.
- 3.2 However, most AOSSG members were advised that paragraphs 12(c), 12(d), 12(e), 12(f), 12(g) and 13 are unnecessary when they do not already meet the offsetting criteria, and would, in general, be overwhelming to users. These members have been informed that financial institutions in particular generally do not store historical data in a manner that would readily enable the information proposed in paragraphs 12(c), 12(d), 12(e), 12(f), 12(g) and 13 to be prepared. For example, disclosure by class of financial instruments would not be possible particularly for paragraphs 12(d) and 12(f) of ED/2011/1 in

situations where bilateral netting or collateral arrangements are contracted on a counterparty basis across various classes of financial instruments. As such, entities may face significant challenges and increased costs to establish and maintain the information systems that would be required.

- 3.3 The AOSSG agrees with paragraph BC77 of ED/2011/1 regarding the user benefit in disclosing the value of collateral pledged or obtained as such information aids in the understanding of an entity's net exposure. However, the AOSSG notes that IFRS 7 *Financial Instruments: Disclosures* already requires detailed disclosures of collateral information in paragraphs 14, 15, 36(a), 36(b) and 38, and ED/2011/1 does not propose an amendment or any cross-reference to existing IFRS 7.
- 3.4 If the ED/2011/1 disclosures were to proceed, most AOSSG members are concerned about the cost burden and relative usefulness of paragraphs 12(c), 12(d), 12(e), 12(f), 12(g) and 13 of ED/2011/1. Most members believe there is a need for those disclosures to be considered and rationalised in conjunction with proposed disclosures in other financial instruments exposure drafts and in IFRS 7 as a whole. Those AOSSG members consider there is an opportunity to have a more cohesive and cost-effective set of disclosure requirements.

4 Transition (Question 5)

- 4.1 The AOSSG supports the proposed retrospective transition requirements in Appendix A of ED/2011/1. However, the AOSSG believes that, if the IASB is going to persist with the proposed guidance on unconditional right and proposed disclosures in paragraphs 12(c), 12(d) and 13 of ED/2011/1, there should be sufficient lead time for entities to reassess their existing set off arrangements and to accommodate changes to their information systems.

28 April 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

AOSSG Islamic Finance Working Group
Comments on *Offsetting Financial Assets and Financial Liabilities*

The Asian-Oceanian Standard-Setters Group (“AOSSG”) is pleased to provide comments from its Islamic Finance Working Group to IASB ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*.

The AOSSG’s Islamic Finance Working Group (“AOSSG IF WG”) was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, China, Dubai, Korea, Malaysia, Pakistan, and Saudi Arabia.

These comments are additional to those in the letter developed by the AOSSG Financial Instruments Working Group dated 28 April 2011, and focus only on issues that are specific to Islamic finance. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and none of those members have expressed significant disagreements.

Offsetting criteria: unconditional right, and intention to settle net or simultaneously

We agree with the proposed requirements. Additionally, we would like to point out that to our knowledge there is no ‘Islamic master netting agreement’. In some jurisdictions, this may be ameliorated by offsetting regulations which put the contracting parties on par with a conventional equivalent arrangement. However, such regulations may not be available in other jurisdictions. Thus, offsetting may be less available to Islamic than conventional entities, because they cannot benefit from the automatic trigger explained in paragraph C9, and their ability to benefit from other triggers will depend on their Sharia or legal advice. Accordingly, an entity may not be able to offset certain Islamic transactions, while their otherwise economically similar conventional equivalents would be offset. Nevertheless, Working Group members view this as a matter to be dealt with by one of the trade bodies, and not one that would necessitate a redrafting of the proposed requirements.

Unconditional right of set-off must be enforceable in all circumstances

The Working Group has no particular concerns with the proposed requirements from an Islamic perspective.

Multilateral set-off arrangements

We agree with the proposed requirements. Additionally, in response to the question “What are some of the common situations in which a multilateral right of set-off may be present?” we would like to highlight that Islamic derivatives are often structured such that in addition to the two main contracting parties, there are suppliers and brokers to provide an underlying commodity to the transaction so that the derivative takes the form of a series of sales and purchases of the underlying commodity in order to comply with Islamic precepts. Depending on the jurisdiction and the commodity exchange, it may be possible to incorporate a multilateral set-off arrangement into the structure. However, the Working Group has not established whether such a set-off is common, and whether it has achieved general Sharia acceptance. The Working Group notes that some Sharia scholars may insist on separating the various sale and re-purchase legs of an Islamic derivative transaction, as well as the amounts payable / receivable therefrom.

Disclosures

For Islamic arrangements where there may be only conditional rights to offset, the requirements of paragraphs 12 and 13 on conditional rights may be unnecessarily onerous and superfluous – especially if an offset is improbable or even remote. Therefore, some Working Group members suggest amending paragraph 15 by requiring these disclosures only if it is probable that a conditional right to offset may be exercised. Other Working Group members believe that the disclosures required by paragraphs 12(c)-12(g) and 13 are not useful even if the conditional right is highly probable to be exercised because, regardless, the financial asset and financial liability would not be permitted to be netted off on the statement of financial position, and the cost in providing the information would outweigh the benefit to users.

Transition

The Working Group does not have any objections to the requirement for retrospective application.

Conclusion

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,



Mohammad Faiz Azmi
Leader of the AOSSG Islamic Finance Working Group