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**Exposure Draft ED/2011/1 Offsetting Financial Assets and Financial Liabilities  
File Reference No. 2011-100**

Dear Sir David,

Deutsche Bank (the Bank) appreciates the opportunity to comment on the Exposure Draft ED/2011/1 Offsetting Financial Assets and Financial Liabilities ('the ED'). The Bank currently performs offsetting of financial assets and financial liabilities over a broad range of instruments and therefore, the proposals in the final standard will have a significant impact on our financial statements.

We welcome the IASB's efforts to enhance the comparability of financial statements and are supportive of convergence between IFRS and US GAAP, as offsetting is the single largest difference between IFRS and US GAAP, continue to strongly support the net presentation of derivatives that are traded under legally enforceable master netting agreements for the following reasons:

- All the individual derivatives are transacted and governed under one legal contract; the ISDA Master Netting Agreement (MNA);
- Counterparty credit risk exists at the MNA level and is measured at the portfolio level for fair value measurement;
- If a default should arise, only one claim will arise for the net exposure that exists for the portfolio of derivatives under the ISDA MNA, with one cash sum ultimately paid to settle the claim;
- Credit risk is therefore managed at the portfolio level, with entities only hedging the net credit risk exposure;
- Given the leveraged/conditional nature, the fair values of derivatives can rapidly change from being assets or liabilities and therefore no information on future cash flows is lost with a net presentation;

- Net presentation is consistent with the way the instruments are managed by the entity and therefore provides the most relevant information to users

Therefore we do not support the path that the Boards have chosen for convergence. Specifically, we do not believe that current IFRS (IAS 32), nor the ED proposals relating to derivatives result in relevant information for financial reporting. We maintain the belief that gross presentation overstates the exposure to credit risk of counterparties. The net presentation provides more relevant information for users of accounts reflecting more fully the credit and liquidity risk position of the entity than gross presentation. We recommend that the Boards reconsider their position.

If the Board's do not find that they can move away from their current proposal, we ask the Boards to consider an alternative model for derivatives within the context of current IAS 32 and US GAAP. This offsetting model would require netting of fully-collateralised (bilateral over-the-counter, exchange traded, and centrally cleared) derivatives in cases where the right to offset the derivatives positions and cash collateral is legally enforceable. For all other contracts netting would only be appropriate in situations where the criteria in current IAS 32 are met. The principle underpinning this approach would be based on the reduction of the counterparty's exposure to credit risk and liquidity risk through the posting of high-credit quality and liquid collateral/margin. Under this model, the substance of the collateral/margin procedures (not the legal form) would drive the presentation in the balance sheet.

Notwithstanding the above, should the Board decide to proceed with the approach set out in the ED, certain of the application guidance in the ED would significantly change current practice under IFRS. Based on discussions with the staff and certain Board members, we understand that this was not the intention of the Board and as such we suggest the following items should be reassessed before moving to a final standard:

- 1) The guidance in paragraph C11 as drafted would prevent offsetting where settlement occurs with a central clearing house but in batches due to volume of transactions and processing constraints. This would alter current practice on offsetting repos and reverse repos with central clearing houses. In this circumstance there exist mechanisms in place such as the auto borrow facility (to reduce risks of fails) and cash collateral to significantly mitigate the exposure to credit risk or liquidity risk such that the flows are in effect equivalent to a single net amount. We therefore recommend wording changes in the appendix to this letter (see question 1) so that the offsetting of repos against reverse repos with central clearing houses is not prohibited. .
- 2) Similar to the issue in paragraph C11, the guidance in C14 is confusing since it could be interpreted to impose a rule that offsetting is not permitted even where the general principles of offsetting are met. Based on discussions with the staff and certain Board members, we understand that it was not the intention to create exceptions prohibiting offsetting where the general principles are met. Specifically, in cases of certain clearing houses, the variation margin payments and contractual cash flows of derivative

assets/liabilities are made in one single payment, there is the intention to settle net. Where this is combined with the legally enforceable right to set off then current industry practice is to offset. The variation margin payment represents a deposit which will be netted against the derivative flows. Since the offsetting criteria are met we believe this offsetting should be required under the ED. We recommend some amendments to the wording of paragraph C14 in the appendix (see question 1) to make it clear that when the offsetting criteria are met then offsetting should not be prohibited. We do not believe that there is a basis to prevent the offsetting of the variation margin amounts against the derivative exposures only because the variation margin represents collateral from a legal standpoint.

The IASB has recently announced the launch of its project to reduce the volume of IFRS disclosures; the disclosures recommended in the ED seem to be at odds with the objectives of that project to assess if the disclosure requirements meet the high-level principles of the standard. We believe that certain of the proposed disclosures are duplicative with what is already required by IFRS 7.15 and IFRS 7.36, specifically in regards to an entity's exposure to credit risks and to assets received as collateral. Therefore the disclosure requirements in the ED should be reassessed to avoid duplication with current IFRS 7 disclosures. Moreover we believe the focus of the disclosures should be on what is netted in the balance sheet as a result of applying the offsetting principles rather than capturing all arrangements subject to set off and collateral arrangements. Should the proposals for disclosures as drafted in the ED be finalised in the new offsetting standard, it would be quite challenging to adopt the standard as some system enhancements would be required.

We hope you find our comments useful and relevant, and look forward to continue working with you in the future. Should you want to discuss in more detail the contents of the letter, please do not hesitate to contact Cynthia Mustafa on the following email address [cynthia.mustafa@db.com](mailto:cynthia.mustafa@db.com) and phone number 020 754 50978.

Please see the appendix for detailed answers to the questions posed in the ED.

Yours sincerely,



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## Appendix

### Question 1—Offsetting criteria: unconditional right and intention to settle net or simultaneously

The proposals would require an entity to offset a recognised financial asset and a recognised financial liability when the entity has an unconditional and legally enforceable right to set off the financial asset and financial liability and intends either:

(a) to settle the financial asset and financial liability on a net basis or

(b) to realise the financial asset and settle the financial liability simultaneously.

Do you agree with this proposed requirement? If not, why? What criteria would you propose instead, and why?

We are in agreement with the general requirements to settle the financial asset and financial liability simultaneously or on a net basis. However, we have the following suggested amendments to the application guidance so that it more fully reflects the general principles and current IFRS practice:

1. The guidance in paragraph C11 appears to prevent offsetting where settlement occurs with a central clearing house but in batches due to volume of transactions and processing constraints. This would alter current practice on offsetting repos and reverse repos with central clearing houses. In this circumstance there are mechanisms in place such as the autoborrow facility and the cash collateral to significantly mitigate the exposure to credit risk or liquidity risk and the flows are in effect equivalent to a single net amount. We recommend amending the paragraph to the current wording in IAS 32.47 (new text underlined, deleted text is struck):

C11 Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. Where there are mechanisms in place such as margin funds, the cash flows are, in effect equivalent to a single net amount and there is no significant exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. In other circumstances, realisation of a financial asset and settlement of a financial liability are simultaneous only if settlements take place at the same moment (i.e. there is exposure to only the net or reduced amount). When this condition is met, the cash flows are, in effect, equivalent to a single net amount and the net amount also reflects the entity's expected cash flows from settling the separate financial instruments. ~~Thus, if settlements take place over a period (even though during this period there is no potential for any change in the value of the financial asset and financial liability, and the period between settlements of the instruments is brief), it is not simultaneous settlement because settlement is not at the same moment. Similarly, Realisation and settlement of an asset and a liability at the same stated time but in different time zones is not simultaneous settlement.~~

2. The guidance in C14 is confusing since it could be interpreted to impose a rule that offsetting is not permitted even where the general principles of offsetting are met. In certain instances with central clearing houses the single net daily cash flow incorporates both margin and the settlement of all flows due on derivative contracts. Where this is combined with the legally enforceable right to set off then current industry practice is to offset. The variation margin payment represents a deposit which will be netted against the derivative flows (changes in fair value). Since the offsetting criteria are met we believe this offsetting should be required under the ED. We also do not believe there is a reason to exclude the offsetting of collateral pledged to an entity that has been sold against an associated asset if the general offsetting criteria are met. We recommend the following amendments to the wording of paragraph C14 to make it clear that when the offsetting criteria are met then offsetting should occur:

C14 Many financial instruments, such as interest rate swap contracts, futures contracts and exchange traded written options, require margin accounts. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets (typically liquid assets). Margin accounts are assets or liabilities that are accounted for separately. Similarly, if an entity sells collateral pledged to it and thus recognises an obligation to return the collateral sold, that obligation is a separate liability that is accounted for separately. An entity shall not offset in the statement of financial position recognised financial assets and financial liabilities with assets pledged as collateral or the right to reclaim collateral pledged or the obligation to return collateral sold unless the general offsetting criteria are met. In particular, in instances where derivatives are cleared through clearing houses where a single net payment is made/received for both the contractual cash flows on the derivatives and related margin payments, an intent to settle net can be substantiated and as such offsetting would be appropriate.

**Question 2—Unconditional right of set-off must be enforceable in all circumstances**

**It is proposed that financial assets and financial liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of set-off. The proposals specify that an unconditional and legally enforceable right of set-off is enforceable in all circumstances (i.e. it is enforceable in the normal course of business and on the default, insolvency or bankruptcy of a counterparty) and its exercisability is not contingent on a future event.**

**Do you agree with this proposed requirement? If not, why? What would you propose instead, and why?**

We are broadly in agreement with the unconditional right to settle net for financial instruments other than derivatives. However, we believe that for derivatives transacted under a Master Netting Agreement (MNA) gross presentation does not present the most relevant information and therefore request that the boards converge to the current US GAAP treatment in FIN 39.

The net presentation of derivatives allows users to better understand the credit risk of the portfolio:

- All the individual derivatives are transacted and governed under one legal contract
- Counterparty credit risk exists at the MNA level and is measured at the portfolio level for fair value measurement purposes.
- If a default should arise, only one claim will arise for the net exposure that exists for the portfolio of derivatives under the MNA, with one cash sum ultimately paid to settle the claim.
- Credit risk is therefore managed at the portfolio level, with entities only hedging the net credit risk exposure.
- Given their leveraged/conditional nature, the cash flows of derivatives can rapidly change from being assets or liabilities and therefore no useful information of future cash flows is lost with a net presentation.
- Net presentation is consistent with the way the instruments are managed.

The liquidity is also better reflected by the net numbers because margin calls are made on the basis of net positions.

Since the net presentation provides more relevant information we recommend that the Boards include an exception to the general principles for balance sheet presentation of derivatives subject to a master netting agreement.

**Question 3—Multilateral set-off arrangements**

**The proposals would require offsetting for both bilateral and multilateral set-off arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements?**

**If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of set-off may be present?**

We support the view that the proposals should be applied to both bilateral and multilateral set-off arrangements. The standard is a principle based standard and therefore, should be applicable to both bilateral and multilateral agreements.

**Question 4—Disclosures**

**Do you agree with the proposed disclosure requirements in paragraphs 11–15? If not, why? How would you propose to amend those requirements, and why?**

We believe that some of the required disclosures are already provided under the current guidance in IFRS 7. For example, paragraph 15 of IFRS 7 contains disclosures relating to collateral pledged and paragraphs 36-38 of IFRS 7 contain disclosures relating to credit risk mitigation. We believe that there is an amount of disclosure overload currently and presenting the same information twice is not helpful to users of financial statements. If these disclosures are deemed beneficial in a single note then the IASB should consider whether the disclosures in IFRS 7 are still required. Therefore the disclosure requirements in the ED should be reassessed to avoid duplication with current IFRS 7 disclosures. Moreover we believe the focus of the disclosures should be on what is netted in the balance sheet as a result of applying the offsetting principles rather than capturing all arrangements subject to set off and collateral arrangements.

We also note that the extent of the disclosures, particularly those relating to amounts which are subject to a right of set off, are far reaching in that the amounts will require disclosure of current accounts and other lending arrangements with a right of set off against deposits and to certain margin lending arrangements. Should the proposals as drafted in the ED be finalised in the new offsetting standard, we believe that we would not be able to adopt the standard earlier than 1 January 2015.

**Question 5—Effective date and transition**

**(a) Do you agree with the proposed transition requirements in Appendix A?  
If not, why? How would you propose to amend those requirements, and why?**

**(b) Please provide an estimate of how long an entity would reasonably require  
to implement the proposed requirements.**

a) Yes.

b) The disclosure requirements are the main incremental effort for IFRS preparers. Should the proposals as drafted in the ED be finalised in the new offsetting standard, we believe that we would not be able to adopt the standard earlier than 1 January 2014.