



INVESTMENT INDUSTRY ASSOCIATION OF CANADA  
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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**Re: Exposure Draft /2011/1 Offsetting Financial Assets and Financial Liabilities (Ref# 2011-100)**

The Investment Industry Association of Canada<sup>1</sup> (“IIAC”) appreciates the opportunity to comment on the proposals contained within your exposure draft (“ED”) on the offsetting of financial assets and financial liabilities. The IIAC supports the International Accounting Standards Board’s and the Financial Accounting Standards Board’s, collectively the “Boards”, efforts to establish a common approach to offsetting. While we are aware of the broad scope and application of the proposals, we have limited our comments solely as they relate to the **offsetting of repo and reverse-repo transactions settled through central clearing houses**. We trust that our comments will be helpful and taken seriously into the Boards’ considerations.

Canada is currently in advanced stages of establishing a new central counterparty and netting facility (“CCP”) for domestic fixed-income (repo) markets. As such, our members and other Canadian stakeholders have a strong interest in the outcome of your current consultation on offsetting, particularly as it relates to transactions through CCPs. Among the major benefits extended to market participants joining CCPs globally is the novation and ‘netting’ process embedded in the CCP’s legal and operational framework. As you are aware, CCPs are also playing a major role in many of the financial reforms currently underway to bring further stability to the global financial system. Generally, our view is that the ED may raise several questions or leaves open to interpretation the accounting treatment for repo and reverse-repo transactions cleared and netted through CCPs, thereby potentially impacting the use of such facilities. Our concerns and need for clarification are illustrated in our responses that follow to the questions posed in the ED.

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<sup>1</sup> The IIAC is the professional Association for Canada’s securities industry. Among the IIAC’s nearly 200 member organizations are all of Canada’s largest investment dealers and Canadian affiliates of major global investment dealers. The IIAC’s mandate includes working with members and other stakeholders in ensuring Canadian capital markets remain among the world’s most efficient.

**ED Question 1 – Offsetting criteria: unconditional right and intention to settle net or simultaneously.**

The proposals would require an entity to offset a recognized 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?

*Unconditional right to set off*

We will speak to the ‘unconditional right to set off’ criteria later in our submission as part of our response to Question 2.

*Intention to net settle*

The intention to net settle criteria can already be found in existing IFRS. Application Guidance paragraph C9 in the ED points out that *the intension to settle on a net basis is typical of centrally cleared financial markets*. This statement can be supported by looking at the rules or operating procedures of CCPs which are designed to facilitate net settlement while also minimizing counterparty (credit) and liquidity risk. We would request that the final guidelines clarify that, as per current IFRS interpretation, repo transactions with a CCP are deemed to have met the intent-to-net settle criteria.

*Simultaneous settlement*

The simultaneous settlement criteria can also be found in existing IFRS. It is our understanding that existing IFRS has been widely interpreted that the operation of a clearing house is deemed to constitute simultaneous settlement and it is only “in other circumstances” that settlement has to occur at the same moment in time for the offset requirements to be met. Specifically IAS 32.48 provides that:

*“Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no 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. Such risk exposures may be significant even though relatively brief. Accordingly, realization of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.”*

Under Application Guidance within the ED, the distinction between transactions conducted with a CCP and those in other circumstances is not as apparent. Additionally, language contained in paragraph C11 and C12 of the Application Guidance could be interpreted to mean that the offsetting of transactions executed within a CCP would not be permissible unless settlement takes place at the same moment. In practice, it is our understanding that due to processing constraints it is not uncommon for fixed-income CCPs to adopt a settlement process that is a variation or combination of batch settlement and trade-for-trade processing such that settlement may not in fact occur at the ‘same moment’. Regardless of whether settlement were to take place at the ‘same moment’ or at a later point during the day, the CCP framework is such that liquidity and credit risk would be effectively mitigated.

Irrespective of whether or not simultaneous settlement is deemed by the Boards to in fact mean the ‘same moment’ in the context of CCPs, to the extent that a CCP can meet the intension to net settle criteria, then it is our view that repo transactions with a CCP still meet the requirements for offsetting.

We believe the proposals should clarify that repo transactions through a CCP be permitted to offset where credit or liquidity risk has been mitigated and the CCP can demonstrate, either through its rules or normal course of operations, that there exists an intension to net settle.

#### *Cash Collateral and Margin Netting*

We also request that further clarification be made as it relates to the offsetting of collateral in the context of a CCP framework. Specifically, it is not clear from the ED proposals if it is the intension of the Boards to prohibit offsetting of assets pledged as collateral that fall under cash margin arrangements within the CCP structure. Fundamental to a CCP’s ability to effectively manage its risk and safeguard its participant is its daily margining process to reflect mark-to-market movements in the securities it clears (i.e. initial and variation margin). It is unclear from the language in Application Guidance C14 as to how such margin arrangements are to be considered. It is our view that collateral netting for CCP’s be permissible where the offsetting criteria can be met.

#### **ED 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 generally supportive of this requirement; however, additional clarification may be helpful as part of future guidance. Given that CCPs or their participants will likely look to the legal community to opine on the existence of ‘unconditional’ set-off rights and the enforceability of such rights, its imperative that Boards’ final guidelines provide the clarity for such work to be undertaken effectively and with minimal interpretation. For example, any distinction by the Boards’ between ‘payment netting’ and ‘close-out netting’ as they relate to CCPs may be helpful. Additional outreach sessions with the legal community may be warranted on the part of the Boards.

#### **ED 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?**

IIAC agrees that the offsetting criteria be applicable to both bilateral and multilateral set-off arrangements.

**ED 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 note that some of the proposed disclosures will impose new requirements on financial statement preparers and will entail considerable efforts on their part. For example, disclosure requirements in ED 12 would require preparers to re-examine all existing contractual arrangements in order to identify the set off provisions and the extent to which those provisions are conditional/unconditional and legally enforceable. Some preparers (and their users) may derive limited value from this exercise. It is important that the benefits to any new disclosure requirements be compared against the efforts for compliance and relief provided where possible.

**ED 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.

IFRS replaces current Canadian GAAP for publicly accountable enterprises beginning January 1 of this year. This conversion is a large undertaking and we would suspect that the adoption of new standards would further complicate their transition unless a reasonable length of time was provided. The effective date for implementing the offsetting proposals should also take into consideration the likely timing of some of the Boards' other current initiatives such that changes can be aligned wherever possible.

Yours sincerely,

“Ian Russell”