FASB Interpretation No. 41

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FIN 41 Summary

Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements

an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39

December 1994

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FASB Interpretation No. 41

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FIN 41: Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements

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FIN 41 Summary

APB Opinion No. 10, *Omnibus Opinion— 1966*, paragraph 7, states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to permit offsetting. This Interpretation modifies Interpretation 39 to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet the conditions in paragraph 3 herein.

This Interpretation is effective for financial statements issued for periods ending after December 15, 1994. Early application is encouraged.

INTRODUCTION

1. The Board has been asked to clarify the circumstances in which amounts recognized as payables under repurchase agreements [1] may be offset against amounts recognized as receivables under reverse repurchase agreements [2] and reported as a net amount in the statement of financial position.

INTERPRETATION

2. Paragraph 5 of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, sets forth the conditions necessary for a *right of setoff* to exist. Those conditions should be present to offset assets and liabilities in the statement of financial position unless

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offsetting is permitted by paragraph 10 of Interpretation 39 or by another accounting pronouncement listed in paragraph 7 of Interpretation 39.

3. Notwithstanding the condition in paragraph 5(c) of Interpretation 39, an enterprise may, but is not required to, offset amounts recognized as payables under repurchase agreements and amounts recognized as receivables under reverse repurchase agreements if all of the following conditions are met:

a. The repurchase and reverse repurchase agreements are executed with the same counterparty.
b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.
c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.[3]
d. The securities underlying the repurchase and reverse repurchase agreements exist in "book entry" form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.[4]
e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraph 4, and the enterprise must have associated banking arrangements in place as described in paragraph 4. Cash settlements for securities transferred are made under established banking arrangements that provide that the enterprise will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be *probable* [5] that the associated banking arrangements will provide sufficient *daylight overdraft or other intraday credit* [6] at the settlement date for each of the parties.
f. The enterprise intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both (1) the cash inflows resulting from the settlement of the reverse repurchase agreement and (2) the cash outflows in settlement of the offsetting repurchase agreement.

The enterprise's choice to offset or not must be applied consistently. Net receivables resulting from the application of this Interpretation should not be offset against net payables resulting from the application of this Interpretation in the statement of financial position.

4. In a securities transfer system for repurchase and reverse repurchase agreements that meets the requirements of paragraph 3(e), cash transfers are initiated by notification from the owner of record of the securities to its securities custodian [7] to transfer those securities to the counterparty to the agreement. Under associated banking arrangements, each party to a same-day settlement of both a repurchase agreement and a reverse repurchase agreement would be obligated to pay a gross amount of cash for the securities transferred from its counterparty but would be able to reduce that gross obligation by notifying its securities custodian to transfer other securities to that counterparty the same day. Thus, each party is responsible for maintaining available cash on deposit only for the amount of any net payable unless it fails to instruct its securities custodian to transfer securities to its counterparty.[8] If both parties transfer

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the appropriate securities in settlement of the repurchase and reverse repurchase agreements, the party with a net receivable will not need any cash to facilitate the settlement, while the party with a net payable will need only to have available the required net amount due at the end of the business day.

EFFECTIVE DATE AND TRANSITION

5. The provisions of this Interpretation are effective for financial statements issued for periods ending after December 15, 1994. Early application is encouraged. Previously issued financial statements may be restated to apply the provisions of this Interpretation retroactively to the date Interpretation 39 was first applied.

This Interpretation was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Swieringa dissented.

Mr. Swieringa disagrees with the exception in paragraph 3 that certain amounts recognized as payables under repurchase agreements and as receivables under reverse repurchase agreements may be offset when the conditions specified in that paragraph are met. He would not permit that exception because those conditions describe a situation in which the right to offset is conditional and both the ability and intent to set off are lacking.

The master netting arrangement referred to in paragraph 3(c) provides for a conditional right to offset. The Board previously concluded in paragraph 49 of Interpretation 39 that offsetting assets and liabilities in the statement of financial position is inappropriate if a party has a legal right of setoff only in the event of default.

There is neither the ability nor the intent to offset payables under repurchase agreements and receivables under reverse repurchase agreements using the settlement mechanism described in paragraphs 3(e) and 4. Under that mechanism, transfers of securities and cash transfers are made on a gross basis. There is no ability to simultaneously settle two offsetting securities transactions. Moreover, there is no intent to settle net. The Board previously concluded in paragraph 45 of Interpretation 39 that offsetting assets and liabilities in the statement of financial position is not representationally faithful if a party does not intend to set off.

The Board specifically addressed repurchase and reverse repurchase agreements in paragraph 22 of Interpretation 39 and concluded that "the gross unconditional receivables and payables recognized in the statement of financial position for these types of assets and liabilities provide useful information about the timing and amount of future cash flows that would be lost if those amounts were offset." No new theory or evidence has been obtained that questions that conclusion.

In Interpretation 39, the Board defined the right of setoff, specified what conditions must be met to have that right, but then provided an exception for certain master netting arrangements. In this Interpretation, the Board now has provided an exception for certain repurchase and reverse repurchase agreements. Moreover, in providing that added exception, the Board has

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introduced a notion of "functional equivalent of net settlement" that it believes "provides evidence of an intent to set off under the limited conditions described in paragraph 3." It is not clear what that notion means or implies, but it may provide the basis for additional exceptions. Mr. Swieringa believes that the time has come for the Board to reconsider the conditions in Interpretation 39 rather than to continue to make exceptions to them.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
James J. Leisenring
Robert H. Northcutt
Robert J. Swieringa

Appendix: BASIS FOR CONCLUSIONS AND COMMENTS ON EXPOSURE DRAFT

Basis for Conclusions

6. This appendix summarizes considerations that some Board members deemed significant in reaching conclusions in this Interpretation. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

7. The Board issued Interpretation 39 in March 1992, effective for financial statements issued for periods beginning after December 15, 1993. Following discussions with the Accounting Standards Executive Committee of the AICPA and with representatives of the securities industry about implementation of that Interpretation, the Board received a request to permit offsetting of payables and receivables recognized in the statement of financial position that are associated with repurchase agreements and reverse repurchase agreements, respectively, that have the same settlement date, are executed with the same counterparty under a master netting arrangement, and settle on the Fedwire Securities Transfer System (Fedwire system).

8. The Fedwire system is structured so that the record of security ownership is transferred and the associated cash payment is made based on the gross amount of each transaction on a delivery-versus-payment basis. The Fedwire system is equipped to settle transactions in different securities separately; that is, only on an individual basis at gross amounts. Offsetting securities transactions cannot be settled simultaneously. The Fedwire system has a *daylight overdraft credit* feature that may be provided through the United States Federal Reserve System

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(Fed). This daylight overdraft credit may be provided to the purchaser's clearing bank by the Fed and, under separate arrangements, the clearing bank may provide daylight overdraft credit to the purchaser until it receives funds to cover net outgoing transfers. The Board acknowledges that the Fed or the clearing banks may revoke or deny daylight overdraft credit privileges at any time and has provided for that contingency, as discussed in paragraph 20, in the requirements of paragraph 3(e). The Board also understands that banks are not permitted by the Fed to disclose their maximum Federal Reserve daylight overdraft credit limits to any external party.

9. The Board considered the request and concluded that if *daylight overdraft or other intraday credit* privileges and certain other conditions (including the existence of a master netting arrangement) are present, then settlement, while on a gross basis, may be considered for accounting purposes as the functional equivalent of net settlement from the perspective of the parties to repurchase and reverse repurchase agreements that have the same settlement date. The Board noted that the constraints of settlement that require a same-day transfer of the gross amounts may not have a gross economic effect on the parties, since only net amounts are required to be available if daylight overdraft or other intraday credit privileges are present.

10. In preliminary deliberations, the Board considered limiting the scope of this Interpretation to transactions that settle on the Fedwire system. However, the Board concluded that such a scope limitation is not warranted. Therefore, the Board intends that this Interpretation apply to any settlements that are made under conditions that include the key elements and transfer system operating characteristics described in paragraphs 3 and 4. If any of those key elements or transfer system operating characteristics are removed from the conditions expected to be present when settlements will occur, offsetting would not be permitted.

11. The Board believes that key elements necessary to permit offsetting are a daylight overdraft or other intraday credit feature in the banking arrangements associated with settlements and the transfer system operating characteristics that are described in and required by paragraph 4. Another key element is that the securities exist in "book entry" form, a requirement specified in paragraph 3(d).

12. The "book entry" feature is a key element because it provides control over the securities. The "controlling" record for a "book entry" security is maintained by the transfer system operator. A securities custodian that has a security account with the transfer system operator may maintain "subsidiary" records of "book entry" securities and may transfer the securities within its subsidiary records; however, a security cannot be traded from the account of that custodian to a new custodian without a "book entry" transfer of the security over the securities transfer system. This form of accounting record facilitates repurchase and reverse repurchase agreement transactions on securities transfer systems.

13. The requirement in paragraph 3(c) for a master netting arrangement is important to this Interpretation because that arrangement effectively consolidates individual contracts into a single agreement between the parties in the event of default. The failure to make one payment under a

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master netting arrangement would entitle the other party to terminate the entire arrangement and to demand the net settlement of all contracts.

14. Paragraph 3 does not apply to amounts recognized for other types of repurchase and reverse repurchase agreements executed under a master netting arrangement; however, those amounts could otherwise meet the conditions of paragraph 5 of Interpretation 39 for a right of setoff. Therefore, unless all conditions in paragraph 5 of Interpretation 39 are met, the amount recognized under a repurchase agreement that does not settle in accordance with all the conditions of paragraphs 3 and 4 of this Interpretation may not be offset against the amount recognized under a reverse repurchase agreement merely because the agreements are executed with the same counterparty under a master netting arrangement. The Board believes that the gross unconditional receivables and payables recognized in the statement of financial position related to those types of repurchase and reverse repurchase agreements provide useful information about the timing and amount of future cash flows that would be lost if those amounts were offset.

Comments on Exposure Draft

15. The Board issued a proposed Interpretation, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, for comment on September 30, 1994 and received 22 letters of comment. Most of the comment letters agreed with the Exposure Draft as written. Certain of the comments received and consideration of them are discussed in the following paragraphs.

16. Some respondents recommended that the final Interpretation address whether repurchase agreements and reverse repurchase agreements with open or unstated maturities would qualify for offsetting. The Board decided to permit the offsetting of payables and receivables related to repurchase and reverse repurchase agreements only in limited conditions that the Board considered to be the functional equivalent of net settlement. The Board believes that the absence of a specified maturity date is inconsistent with those limited conditions and, thus, concluded that offsetting is not permitted for agreements with open or unstated maturities. The limited conditions in paragraph 3 do not negate the underlying required condition of paragraph 5(c) of Interpretation 39 that "the reporting party intends to set off." Rather, the Board determined that net settlement or "the functional equivalent of net settlement" provides evidence of an intent to set off under the limited conditions described in paragraph 3. Payables and receivables related to repurchase agreements and reverse repurchase agreements with open or unstated maturities do not meet the condition in paragraph 3(b) that requires the same settlement date. Accordingly, paragraph 3(b) has been modified to clarify the Board's intention for the requirement to be the same explicit settlement date specified at the inception of the agreements.

17. A question was raised concerning the use of accounts with multiple banks by the same party. In view of the Board's objective to permit offsetting under the limited conditions described in paragraph 3, where those conditions are considered to be "the functional equivalent

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of net settlement," the Board determined that it is necessary to clarify those conditions by stipulating that the enterprise use the same account at a single bank or other financial institution in transacting both the cash inflows and the cash outflows in settling the repurchase agreement and reverse repurchase agreement. The Board believes that the reporting entity's use of an account at one financial institution to receive cash inflows and a different account at a financial institution to disburse offsetting cash outflows is inconsistent with the objective of "the functional equivalent of net settlement" of the repurchase and reverse repurchase agreements. In contrast, it is not necessary that both parties use the same bank or other financial institution. The Board added paragraph 3(f) to specify that the same account at the clearing bank or other financial institution be used at the settlement date in transacting both (a) the cash inflows resulting from the settlement of the reverse repurchase agreement and (b) the cash outflows in settlement of the offsetting repurchase agreement.

18. Some respondents raised questions about disclosures required by FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, of amounts offset under this Interpretation. Appendix B of Statement 105 indicates that repurchase agreements accounted for as a borrowing by the issuer have no off-balance-sheet risk for either the holder of the security or the issuer. All the credit risk related to repurchase agreement payables and reverse repurchase agreement receivables that are offset in accordance with this Interpretation is reflected in the net amount included in the statement of financial position. Therefore, there is no off-balance-sheet credit risk under Statement 105. All significant market risk for a repurchase agreement accounted for as a collateralized borrowing is reflected in the repurchase agreement security that is reported in the statement of financial position. Securities sold subject to repurchase agreements are not affected by this Interpretation and are reported "gross" in the statement of financial position and, thus, are not subject to disclosure under Statement 105.

19. Some respondents also raised questions about disclosures required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, of amounts offset under this Interpretation. Disclosure of the net fair value of repurchase agreement payables and reverse repurchase agreement receivables whose carrying amounts are offset in accordance with this Interpretation complies with the requirements of Statement 107. FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, amends Statement 107 to also require disclosure of the net carrying amount when the net fair value is disclosed. It is possible that the net carrying amount could be a receivable and the net fair value could be a payable or vice versa.

20. One respondent noted the possibility that daylight overdraft credit privileges might be revoked or denied at any time at the prerogative of the transfer system operator or the financial institutions that serve as securities custodians. Daylight overdraft or other intraday credit privileges may be granted to a financial institution by the transfer system operator and to a reporting entity by a financial institution executing transactions on behalf of the reporting entity. Additionally, a reporting entity or a financial institution may be required to maintain or deposit

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collateral in support of daylight overdraft or other intraday credit and may be required to pay a fee for such credit. Since the availability of daylight overdraft or other intraday credit is a requirement necessary to permit offsetting under this Interpretation, the possibility that daylight overdraft credit privileges might be revoked or denied at any time is a contingency that must be evaluated. The Board believes that offsetting should not be permitted unless it is probable that daylight overdraft credit privileges will exist for the reporting entity at the settlement date. The availability of daylight overdraft credit to a financial institution executing transactions on behalf of a reporting entity is important only to the extent that it affects the daylight overdraft credit available to the reporting entity. A requirement that a reporting entity or a financial institution maintain or deposit collateral in support of daylight overdraft credit would not preclude an entity from offsetting under the conditions of this Interpretation. There is a concern that a change in the availability of daylight overdraft credit privileges could cause changes in the presentation of assets and liabilities and, where applicable, in the minimum regulatory capital required for some financial institutions. The Board acknowledges this concern and notes that offsetting of amounts under this Interpretation is permitted but not required.

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Footnotes

FIN41, Footnote 1--For purposes of this Interpretation, a repurchase agreement (repo) refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The "payable" under a repurchase agreement refers to the amount of the seller-borrower's obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a "reverse repo."

FIN41, Footnote 2-- For purposes of this Interpretation, a reverse repurchase agreement (reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The "receivable" under a reverse repurchase agreement refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a "repo."

FIN41, Footnote 3--The qualifications for a master netting arrangement are stated in paragraph 10 of Interpretation 39 and are discussed in paragraphs 21 and 30 of that Interpretation.

FIN41, Footnote 4--"Book entry" securities meeting the criterion in paragraph 3(d) exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting of securities held in "book entry" form solely because other securities of the same issue exist in other forms.

FIN41, Footnote 5--The term *probable* is used in this Interpretation consistent with its use in paragraph 3(a) of FASB Statement No. 5, *Accounting for Contingencies*, to mean that a transaction or event is likely to occur.

FIN41, Footnote 6--*Daylight overdraft or other intraday credit* refers to the accommodation in the banking arrangements that allows transactions to be completed even if there is insufficient cash on deposit during the day provided there is sufficient cash to cover the net cash requirement at the end of the day. That accommodation may be through a credit facility, including a credit facility for which a fee is charged, or from a deposit of collateral.

FIN41, Footnote 7--The securities custodian for a securities transfer system may be the bank or financial institution that executes securities transfers over the securities transfer system, and "book entry" securities exist only in electronic form on the records of the transfer system operator for each entity that has a security account with the transfer system operator. "Book

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entry" securities exist only as items of account on the "controlling" records of the transfer system operator. Banks or other financial institutions may maintain "subsidiary" records of "book entry" securities. "Book entry" securities may be transferred on the subsidiary records of a bank or financial institution but, for entities that have a security account with the transfer system operator, may be transferred from the account of such an entity only through the transfer system operator.

FIN41, Footnote 8--Failure by either party to instruct its securities custodian to transfer securities owned of record would result in that party's failing to receive cash from the counterparty and, thereby, would require that party to have available cash on deposit for the gross payable due for securities transferred to it. The failure also should be an event of default under the master netting arrangement required by paragraph 3(c). The event of default, in turn, should entitle the other party to terminate the arrangement and demand the immediate net settlement of all contracts.

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