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Banks (Citi)
Global

US & European Wholesale Banks

New Netting Disclosure, Focus on Leverage

- Industry Overview

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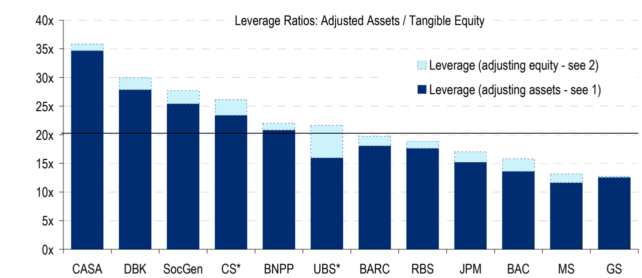
- **Accounting Rules Distort Balance Sheet Size** — US GAAP and IFRS rules which govern the offsetting of derivative assets and liabilities on the balance sheet are different, and the accounting boards have been unable to reach a converged solution. As a result, IFRS banks' balance sheets appear relatively larger than equivalent US banks (Figure 6).

- **New Disclosures for Comparison** — The IASB and FASB didn't agree on consistent netting rules, but they did introduce a new disclosure requirement from Q1 2013 (Figure 9) – presenting both 'grossed-up' and 'netted' versions of the reported balance sheet. For major wholesale banks, gross US GAAP balance sheets are twice the size of reported, while 25% larger under IFRS (Figure 1). The common misconception that IFRS does not net any derivatives is untrue.

- **Leverage the Next Shoe to Drop?** — As highlighted in Road Ahead – Two-Speed Europe, we believe that focus could increasingly shift to leverage ratios in 2013. This is driven by two factors: a continued focus on the size and funding of European banks' balance sheets, and a potential challenge to the consistency and efficacy of RWAs from a Basel Committee review, due to report its initial conclusions in early 2013.

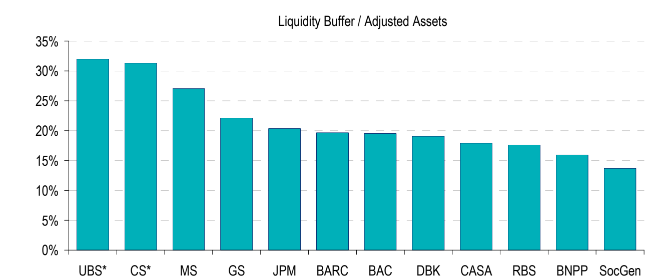
- **Risk Experience Matters, CASA & DBK Most At Risk** — On a 'netted' basis, European wholesale banks clearly have higher leverage ratios (18-35x) than their US counterparts (c15x). Differences in risk experience go some way to explain European banks' lower risk-weights and higher leverage – see Figure 5. However, risks remain from the Basel review; past experience no guarantee of future, differences in types of models and calibration. We continue to believe that the risk is greatest for banks with the highest leverage ratios, notably CASA & Deutsche Bank.

Not All Banks Are Equal on Leverage



Source: Company reports & Citi Research estimates. Refer to footnotes of Figure 7

Liquidity Buffers Can Distort Leverage



Source: Company reports & Citi Research estimates. Refer to footnotes of Figure 8

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

New netting disclosure to aid leverage comparisons

IFRS and US GAAP have different rules on offsetting of financial assets and liabilities (eg when banks can net derivatives on the balance sheet). US GAAP rules allow for significantly more offsetting than IFRS, which means that IFRS banks report relatively larger balance sheets than they would if they applied US accounting rules. As total assets form the numerator in leverage calculations, the accounting differences mean that US GAAP and IFRS leverage ratios are not comparable without adjustment.

The IASB and FASB (the respective standard setters for IFRS and US GAAP), were asked by the G20 to come up with a single set of rules to govern when banks may offset financial assets and liabilities, but they were unable to reach a consensus. Instead, they agreed on common disclosures for both IFRS and US GAAP banks, intended to enable more like-for-like comparisons of total assets and leverage.

In anticipation of these new disclosures, which are required from Q1 2013, we provide an overview of the accounting differences and highlight the impact of these, which we believe is not well understood by the market, and make estimates of US and European wholesale banks' leverage ratios calculated on a more consistent basis.

Comparing the size of banks' balance sheets

Derivatives netting under US GAAP is significantly greater than under IFRS which drives gross distortions of balance sheet size

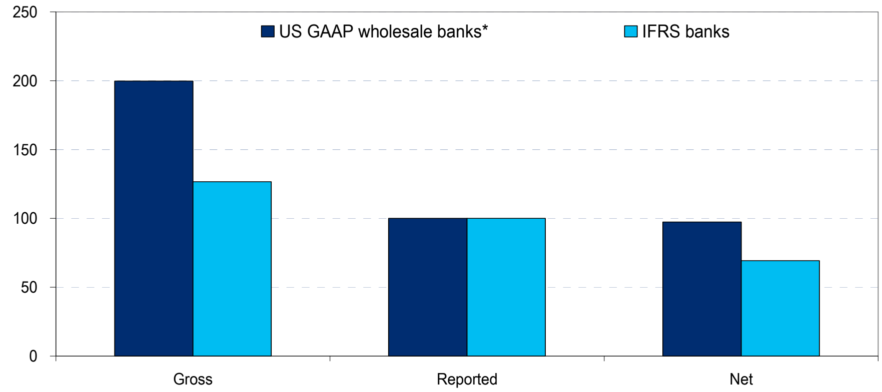
Our analysis focuses on the largest US and European wholesale banks, as these banks have the most significant concentrations of derivative exposure, and therefore are most affected by offsetting rules. US banks apply US GAAP while European banks apply IFRS, with one exception (Credit Suisse, which applies US GAAP).

Due to the differences between IFRS and US GAAP accounting rules, we estimate that the aggregate gross balance sheet of major US GAAP banks is twice the size of the reported balance sheet, which is largely driven by the gross-up of derivative assets and liabilities. By contrast, we estimate the aggregate IFRS 'gross' balance sheet is 'only' 25% higher than reported. This may be contrary to common perception, but as we discuss below IFRS does permit some netting of derivatives.

Comparing balance sheets on a net basis (with 'full' netting of derivatives, repos, brokerage receivables, and associated collateral), the IFRS balance sheet is typically c70% of the reported balance sheet, whereas the US GAAP balance sheet is largely unchanged. These comparisons are shown in Figure 1, which highlights the extent to which IFRS and US GAAP differences can distort impressions of balance sheet size.

Aggregate gross balance sheets of US wholesale banks twice the size of reported balance sheets

Figure 1. Wholesale Banks – Indexed US GAAP and IFRS balance sheet sizes (reported = 100)



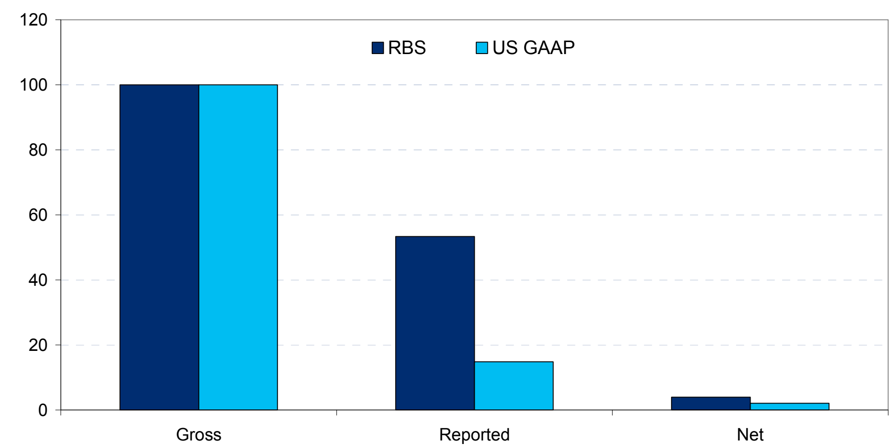
Source: Company Reports and Citi Research Estimates
Note: US GAAP based on major US GAAP reporting banks including Bank of America, Credit Suisse, Goldman Sachs, JPMorgan, Morgan Stanley & assuming other collateral arrangements comparable to JPM disclosure. IFRS based on major IFRS reporting banks including Barclays, BNP Paribas, Deutsche Bank, SocGen, RBS and UBS.

RBS and Deutsche Bank disclosures illustrate the issue

Relatively few banks currently provide full disclosure of the differences between gross, reported, and net balance sheets. However, disclosures by RBS and Deutsche Bank help illustrate the significance of the issue. RBS provides a gross to net analysis of its financial asset exposure, splitting the amounts offset between those permitted under IFRS and other offsetting amounts not netted on balance sheet. In Figure 2 we compare RBS' gross, reported, and net derivative asset position to our aggregate calculation for US GAAP banks (gross exposure is indexed to 100 in both cases).

Comparing on a 'fully netted' basis both RBS and US GAAP banks' exposures are c2-4% of gross (replacement value) exposures. However, comparing gross and reported figures, RBS is able to net only c50% of its derivative assets on the balance sheet, compared to c85% for US GAAP-reporting banks.

Figure 2. RBS vs. US GAAP Derivatives Netting (gross = 100)

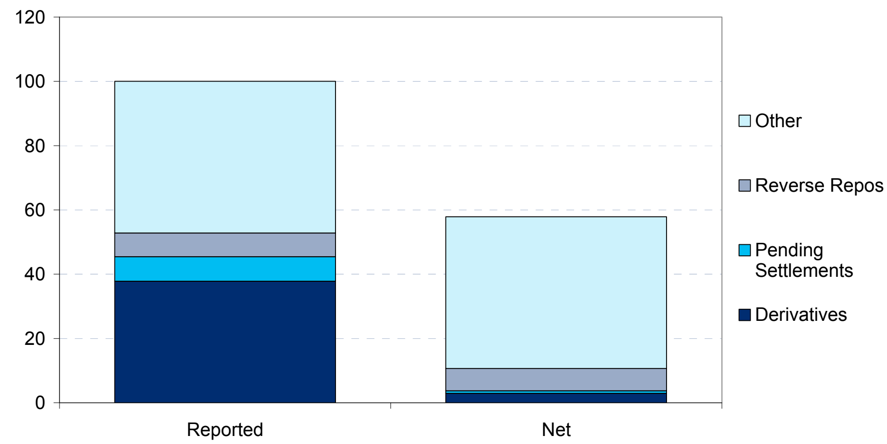


Source: Company Reports and Citi Research Estimates
Note: US GAAP based on major US GAAP reporting banks including Bank of America, Credit Suisse, Goldman Sachs, JPMorgan, Morgan Stanley & assuming other collateral arrangements comparable to JPM disclosure

Deutsche Bank provides analysis of additional offsetting amounts not permitted to be presented net on the IFRS balance sheet, as shown in Figure 3. Deutsche's figures are consistent with RBS in respect of the large additional netting of derivatives not permitted on balance sheet. It also highlights another area of inconsistency; industry practice in the US is that receivables and payables on unsettled regular way trades may be offset. This is not permitted under IFRS[1].

Deutsche Bank disclosure highlights US netting of receivables and payables from unsettled trades, not permitted under IFRS

Figure 3. Deutsche Bank Balance Sheet Netting (reported = 100)



Source: Company Reports and Citi Research Estimates
Note: Reported balance sheet rebased to 100

US GAAP permits more netting of derivatives

We include a more detailed analysis of the offsetting accounting rules, the relevant differences between US GAAP and IFRS, and the new disclosure requirements on page 9. The treatment of derivatives is the most significant difference between IFRS and US GAAP rules on offsetting, so we provide a brief summary here.

IFRS permits offsetting in limited circumstances

IFRS requires the following criteria to be met before derivative assets and liabilities may be offset on the balance sheet:

- An unconditional current **legally enforceable right to set off** the recognised amounts in all circumstances; **and**
- **The intent to settle on a net basis**, or to realise the asset and settle the liability simultaneously (eg through a clearing house).

While US GAAP allows derivative netting based on master netting agreements

The US GAAP criteria for derivatives are slightly different. US GAAP provides a right of offset for derivatives when the following conditions are met:

- Each of the two parties owes the other determinable amounts;
- The company has **the right to offset the amount owed** by the other party; and
- There is **reasonable assurance that the right of offset would be upheld in bankruptcy.**

[1] The US FASB recently issued a proposed amendment to the new disclosure requirements, limiting the scope of the new disclosure requirements to derivatives, repos and reverse repos, and therefore excluding unsettled trade receivables and payables. For more details see page 12.

Therefore, the key practical differences between IFRS and US GAAP are whether master netting agreements (MNAs) constitute a basis for offsetting, and the requirement of intent to settle net (or settle simultaneously) under IFRS. MNAs do not generally provide an unconditional right of offset, meaning that many derivative assets and liabilities cannot be offset under IFRS. On the other hand, US GAAP does permit offsetting of derivatives exposures subject to an MNA, with the less rigorous condition that the terms of the MNA are reasonably assured of being upheld in the case of counterparty default.

Common misconception that IFRS does not permit any derivative netting

Analysts and investors have often attempted to bridge the gap between IFRS and US GAAP reported assets based on the concept of 'netted' derivatives. However, there has been one key misconception. Often, market observers have misunderstood the IFRS approach as one of not netting down derivatives. This is strictly untrue, as IFRS does allow netting, albeit in much more limited circumstances than is permitted under US GAAP.

The new disclosure requirements to be applied from Q1 2013 will require banks to provide a reconciliation table showing the gross, balance sheet, and net positions for derivatives and other financial instruments. The basic table template is as shown in Figure 4.

This disclosure **will** enable investors to compare banks on a like-for-like basis using either the gross or net exposure (as well as highlighting how much offsetting occurs on the balance sheet), but **will not** mean that investors are able to translate between IFRS and US GAAP balance sheet presentations[2].

Figure 4. Illustration of new disclosure requirement – gross to net reconciliation

	(a)	(b)	(c) = (a) – (b)	(d)		(e) = (c) – (d)
Description	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off on the balance sheet	Net amounts of recognised financial assets on the balance sheet	Related amounts not set off in the balance sheet		Net amount
				Financial instruments	Cash collateral received	
Derivatives	100	20	80	20	50	10
Repos	200	0	200	180	0	20
Other	50	5	45	0	0	45
Total	**350**	**25**	**325**	**200**	**50**	**75**

Source: IASB, Citi Research

Leverage coming into greater focus

We expect the upcoming Basel RWA review to increase focus on leverage ratios

The level of total assets forms the numerator in leverage calculations, and as such a disconnect between the level of assets reported on US GAAP and IFRS balance sheets has a knock-on effect on leverage ratios. We believe it is important for investors to be aware of this, particularly as leverage is becoming an increasingly important metric for the market, in our view. This is driven by banks' funding pressures, and by concerns that RWA measures may come into question.

The euro zone crisis and the US money market storm have raised increased concerns about the size & funding of the European banks' balance sheets. If anything, the growing reliance of the sector on ECB funding – notably peripheral banking systems – has highlighted the 'dislocated' nature of their deleveraging story. In our latest Road Ahead – Two-Speed Europe report (5 September 2012), we highlighted that wholesale bank deleveraging has generally been 'smoother' than retail banking. Even then, this has been scant comfort for bears on the size of balance sheets.

[2] It was deemed too laborious for banks to have to prepare and maintain two sets of accounting records under both US GAAP and IFRS rules.

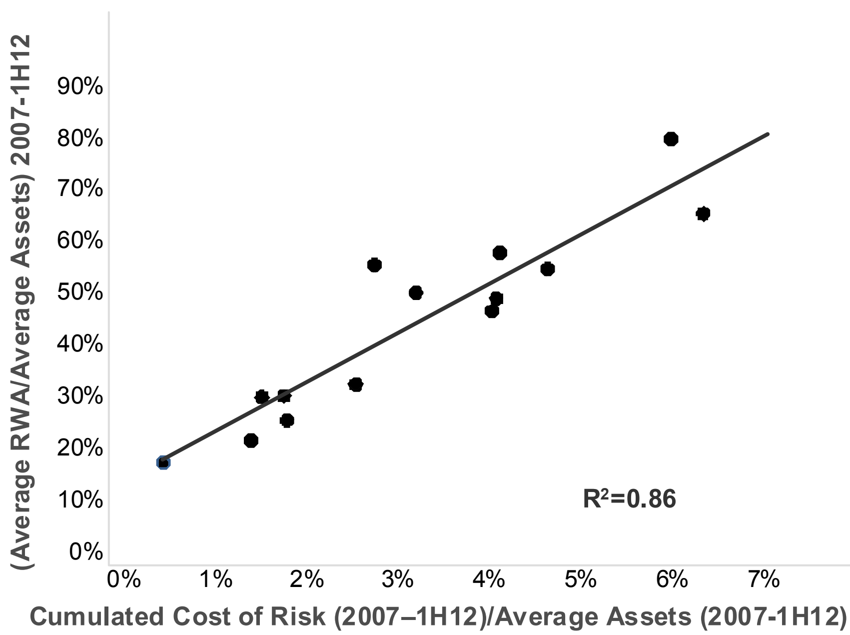
In Road Ahead, we also argued that leverage could be the next shoe to drop. Indeed, the Liikanen Group raised the issue of risk-weights on both the trading book and real estate assets – recommending floors as well as questioning the consistency and efficacy of internal model-based inputs. Equally importantly, the upcoming RWA review (http://www.bis.org/publ/bcbs220.pdf), focused on both the Banking book and the Trading book, could further cloud concerns over risk-weightings and add weight to leverage ratios.

The Weighting Game

Retail risk experience is the primary driver of differences in risk-weighting, in our view

In our view, the primary driver of differences in risk-weights is the risk experience (refer to Figure 5), which has primarily affected Retail/Commercial operations – refer to The Weighting Game (20 June 2011).

Figure 5. Cost of Risk Has Been Correlated To Risk-Weights



Source: BNP Paribas based on sample of European banks, Bank of America, JPMorgan and Wells Fargo;

But RWAs present some risks

At the same time, the following risks cannot be ignored:

- **Past experience not guarantee of future:** The pro-cyclicality in the 'risk-based' system is that, following an extended period of benign credit quality, relatively low risk-weights could leave banking systems relatively undercapitalized. Basel 3 aims to overcome this pro-cyclicality via TTC (through-the-cycle) estimates of default and counter-cyclical capital buffers although this may not go far enough.

- **Type of model:** Differences in supervisory approaches with some jurisdictions relying more heavily on internal models approach and integrated VaR models while others continue to weigh more on the standardized approach.

- **Model calibration:** Calibration of model parameters such as PD and LGD estimation could also drive significant differences in risk-weights. For example, in Weighing Down (18 January 2012), we identified that not all banks use a TTC approach. Some banks adopt a hybrid approach while Deutsche Bank relies upon a less-conservative PIT (point-in-time) approach.

We expect preliminary conclusions of this top-down and bottom-up analysis being conducted by the SIG (Standards Implementation Group) to be released in early-2013 (originally planned for 4Q12). If the analysis is critical of consistency of current risk-weighting practices across banks and jurisdictions, as is our expectation, we would expect a greater market focus on balance sheet size and leverage will likely follow.

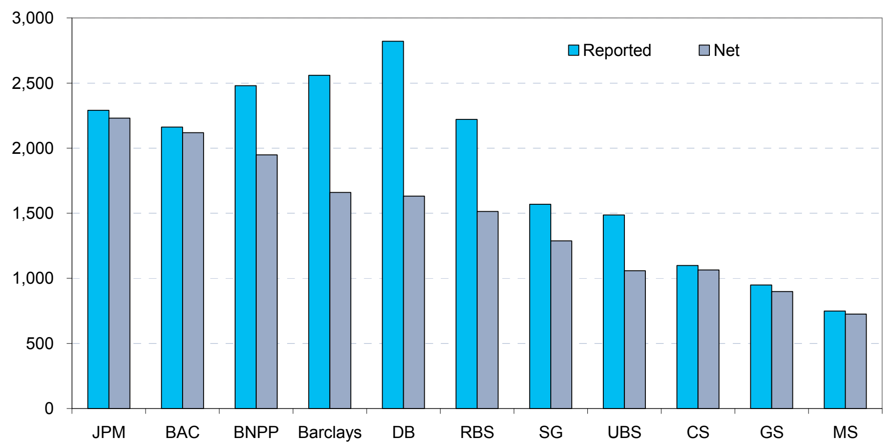
Not all banks are equal on leverage

We have estimated net balance sheet size on a comparable basis

In anticipation of this new disclosure, we have analysed (based on in some cases limited reported information) the difference between reported and net balance sheets for the major wholesale banks in Europe and the US, based on H1 2012 data (supplemented by 2011 annual report data where necessary). We start by considering the pecking order of banks by total balance sheet size.

On a reported basis, as shown in Figure 6, the largest major European/US wholesale banks by total assets are Deutsche Bank, Barclays and BNP Paribas followed by JPMorgan, RBS and Bank of America. However, on a netted basis, the pecking order changes with JPMorgan, Bank of America and BNP Paribas followed by Barclays, Deutsche Bank and RBS. Lower levels of corporate disintermediation in Europe also contribute to larger balance sheets.

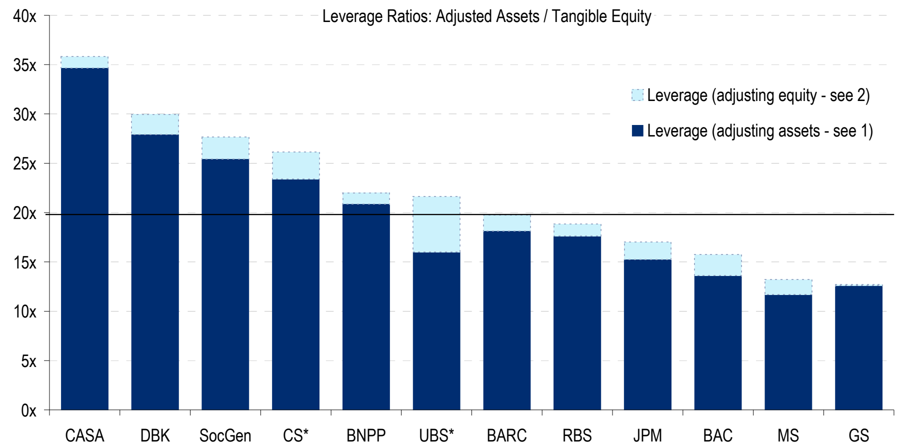
Figure 6. Balance Sheet Pecking Order – Reported & Net ($USbn)



Source: Company Reports and Citi Research Estimates
Note: US GAAP based on major US GAAP reporting banks including Bank of America, Credit Suisse, Goldman Sachs, JPMorgan, Morgan Stanley & assuming other collateral arrangements comparable to JPM disclosure

Turning to leverage ratios, we have calculated adjusted leverage ratios for the major US and European wholesale banks, which are shown in Figure 7. We include two separate leverage calculations. In both calculations we adjust reported total assets for additional offsetting of derivatives, repos, and brokerage receivables not permitted on balance sheet, as well as excluding any insurance assets. The denominator in our default calculation is tangible shareholders' equity (excluding FV of own debt adjustments and including contingent capital), and in our alternative calculation we take a more penal view of equity components, deducting off-balance sheet pension deficits (IFRS only) and deferred tax assets related to carried forward operating losses.

Figure 7. Not All Banks Equal On Leverage



Source: Company Reports and Citi Research Estimates
Note: *CS & UBS adjusted to targeted balance sheet reductions
(1) Leverage = Adjusted Assets / Tangible Equity = (Assets - netted derivs - insurance - repos - brokerage receivables) / (Tangible Equity – FVOD + contingent capital)
(2) Leverage = Adjusted Assets / Adjusted Tangible Equity = Adjusted Assets / (Tangible Equity - FVOD - DTA NOL - Pension deficit + contingent capital)

It is not a surprise that US banks' leverage ratios are comparatively below those of their European peers. This is partly driven by the structure of US and European mortgage markets (particularly Fannie Mae/Freddie Mac's significant role in the US) as well as lower risk-weights supported by a generally better risk experience in Europe over the past cycle.

CASA and Deutsche Bank run with the highest leverage ratios, on our estimates

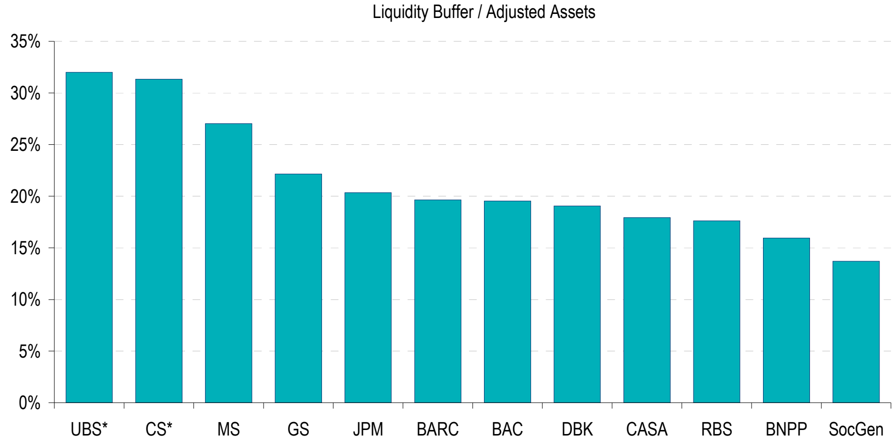
From a European banks' perspective, CASA and Deutsche Bank run with the highest leverage ratios and therefore carry the greatest risk of capital raising to improve both capital & leverage ratios, in our view. On the other hand, the major UK banks tend to have lower leverage ratios and, together with the Swiss banks, have benefited from the greatest asset deleveraging to date.

Swiss banks run with the highest liquidity buffers relative to the balance sheet

It is also worth noting that the major Swiss banks also have the highest levels of liquidity buffer as a proportion of adjusted assets, as they have liquidity coverage ratios (LCR) well above Swiss & Basel requirements, as shown in Figure 8. CS has disclosed that its liquidity ratios are well in excess of requirements while UBS reported an LCR ratio of 113%. The Swiss approach is similar to the Basel 3 LCR although the requirements went into effect at the end of 2Q10.

Swiss Banks carry highest levels of liquidity buffers

Figure 8. Swiss Banks Carry Highest Levels of Liquidity Buffers



Source: Company Reports and Citi Research Estimates
Note: See comments in Figure 7 for definition of adjusted assets;
Liquidity buffers definitions: US banks = company defined liquidity reserves; Euro banks = assets eligible to central banks + cash at central banks; UK banks = company defined liquidity reserves; Swiss banks = Swiss liquidity buffers, with definitions similar to Basel 3 liquidity buffers (level 1 & level 2)

IFRS and US GAAP offsetting accounting rules

Both IFRS and US GAAP contain rules setting out when financial assets and financial liabilities can be offset (netted off) on the balance sheet. This relates to the offsetting of derivative assets and liabilities, repurchase and reverse repurchase agreements, and brokerage receivables.

Offsetting does not affect shareholders' equity or earnings

The offsetting rules only affect the gross assets and liabilities on the balance sheet; there should be no impact on the reported shareholders' equity (net asset value) or earnings. However, the offsetting rules have a significant impact on the apparent leverage of the bank. The more offsetting is permitted, the lower the apparent leverage. US GAAP permits more netting off than IFRS, meaning that US banks balance sheets typically have lower reported gross assets and leverage than equivalent European banks. From Q1/H1 2013[3], banks will have to provide enhanced disclosures which should enable investors to calculate comparable leverage ratios (refer to Figure 9).

IFRS rules

IFRS focus is on expected future cashflows; relatively less netting allowed

IFRS rules focus on reflecting the expected future cashflows, and require financial assets and financial liabilities to be offset on the balance sheet **only** when a company:

- Has a current **legally enforceable right to set off** the recognised amounts; **and**
- **Intends to settle on a net basis**, or to realise the asset and settle the liability simultaneously (eg through a clearing house).

A current legally enforceable right must not be contingent on a future event; and must be enforceable in all of the following circumstances:

- During the normal course of business;

[3] First interim reporting period starting on or after 1 January 2013, assuming a December year-end.

- In the event of default, and
- In the event of insolvency or bankruptcy of the company or its counterparties.

US GAAP rules

Both US GAAP and IFRS standards have a general principle that financial instruments can only be offset if there is a legal right of offset, and the company intends to settle net. However, US GAAP contains some exceptions for derivatives and repurchase/reverse repurchase agreements[4] and therefore allows greater offsetting than IFRS.

US GAAP provides a right of offset when the following conditions are met:

- Each of the two parties owes the other determinable amounts;
- The company intends to offset (this is not a requirement for derivative financial assets and liabilities);
- The company has the right to offset the amount owed by the other party; and
- There is reasonable assurance that the right of offset would be upheld in bankruptcy.

Derivatives subject to master netting agreements offset under US GAAP

In practice this means that many exposures subject to a master netting agreement (MNA) may be offset. An MNA is an agreement between counterparties that permits the net settlement of all outstanding contracts through a single payment in a single currency in the event of default on or termination of any one contract. MNAs take different forms and may permit netting of payments under a variety of master or other trading agreements between counterparties. Some master netting agreements permit netting on a regular basis (monthly or quarterly, for example), while others permit netting only when the underlying master or other agreements are terminated.

In general US GAAP permits that derivatives exposures subject to a master netting agreement can be offset. Some other exposures may be offset where there is both an MNA and the intention to settle net. In addition, cash collateral may be netted off against some derivatives.

US GAAP also permits broker dealers to offset brokerage receivables and payables

Finally, brokerage receivables and payables arising from unsettled regular way[5] transactions may be netted down if the company is a broker-dealer entity for US GAAP purposes[6].

Offsetting is optional in US GAAP, but is an accounting policy designation and must be applied consistently across all eligible exposures. In practice we assume that it will generally be beneficial for US banks to apply offsetting because this improves leverage ratios.

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[4] Interpretations 39 and 41.

[5] A regular way purchase or sale is "a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned" (IAS 39 paragraph 9).

[6] ASC 940-320-45-3

Key differences

The differences between IFRS and US GAAP largely stem from conceptual differences between the two standards. The US GAAP rules are intended to provide investors with information on the credit and liquidity risks from financial (particularly derivative) assets and liabilities, while the IFRS rules are focused on providing information on future cash flows, splitting the resources and obligations of the company unless they definitively represent a single asset or liability.

The key practical differences between IFRS and US GAAP are whether master netting agreements constitute a basis for offsetting, and the requirement of intent to settle net (or settle simultaneously) in order to offset derivatives under IFRS.

As IFRS requires that companies have a current, unconditional and legally enforceable right to settle net, the presence of an MNA is not sufficient to permit offsetting, as an MNA generally does not provide an unconditional right of offset. On the other hand, US GAAP does permit offsetting of derivatives exposures subject to an MNA, as well as other exposures where there is an MNA and the intention to settle net.

IFRS does not have any equivalent guidance to the broker-dealer netting allowed in US GAAP so this may make a material difference to some banks with significant broker-dealer activities. For example, Credit Suisse, which reports under US GAAP, has disclosed that at the end of 2009 it netted off CHF 28bn of such receivables and payables within its broker-dealer subsidiaries. Similarly Deutsche Bank, which reports under IFRS, discloses that if it reported under US GAAP it would have netted out €153bn of such pending settlements at the end of June 2012 (€105bn at end December 2011).

It is our understanding that some banks' offsetting practices for centrally-cleared repos/reverse repos under IFRS are similar to US GAAP so we do not expect this to be a major difference, although Deutsche Bank reports it would have had a further €10bn of netting had it applied US GAAP guidance on reverse repos (at H1 2012 and FY 2011).

While offsetting is an accounting policy choice under US GAAP, we do not expect that many companies (particularly financial institutions) would choose gross presentation when offsetting was available, and therefore this is not a significant difference in the two sets of rules.

New disclosure requirements

IASB and FASB failed to agree on common offsetting policy

The G20 and the Financial Stability Board requested that the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) converge their rules on offsetting to improve international comparisons of banks' balance sheets. After more than two years' work, the two Boards voted to keep their existing, differing rules on offsetting[7]. Instead, the two Boards agreed to require additional disclosures about offsetting[8].

Introduction of common disclosure aimed at bridging the gap

The new joint disclosure requirements are intended to enable investors to bridge the gap between the reported leverage of companies reporting under IFRS and US GAAP. However, the requirements do not require a full reconciliation of the amounts that would be set off under both IFRS and US GAAP, as it was considered too costly for companies to monitor compliance with the two sets of accounting rules.

[7] The IASB made some minor clarifications of its existing rules to address some inconsistencies identified in application of the rules.

[8] For IFRS reporters, the new disclosures were issued in *Disclosures – Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)*, published in December 2011.

Instead, the new disclosures require reconciliation of the gross position of financial assets and liabilities, the amounts presented on balance sheet, and the net amount incorporating related amounts not offset on the balance sheet. This will enable investors to compare balance sheet leverage on a like-for-like basis, using either the gross position or net position, and should provide greater clarity on the leverage of banks reporting under IFRS vs. those under US GAAP.

Scope

The initial scope of this disclosure requirement was for all financial instruments which are either:

- Set off under the applicable offsetting rules;
- Subject to an enforceable MNA or similar arrangement, irrespective of whether they are offset on the balance sheet.

The IFRS scope remains unchanged. However, FASB recently published proposals to limit the scope of the US GAAP disclosure requirement[9], suggesting that the US GAAP disclosure be limited to derivatives, repos and reverse repos, and securities lending arrangements. The main impact of this for banks is to exclude regular-way trade receivables and payables from the scope, which will result in a difference in the disclosure between US GAAP and IFRS banks.

The scope change proposals are open for comment and would take effect from Q1 2013 if adopted. This is somewhat unfortunate in our view, as it means comparisons on a gross basis will remain somewhat inconsistent. As we note above, the impact of such netting is not immaterial for the large broker-dealers.

The basic requirement, which is required to be presented in tabular form unless another format is more appropriate, is as shown in Figure 9.

Figure 9. Illustration of new disclosure requirement – gross to net reconciliation

	(a)	(b)	(c) = (a) – (b)	(d)		(e) = (c) – (d)
Description	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off on the balance sheet	Net amounts of recognised financial assets on the balance sheet	Related amounts not set off in the balance sheet		Net amount
				Financial instruments	Cash collateral received	
Derivatives	100	20	80	20	50	10
Repos	200	0	200	180	0	20
Other	50	5	45	0	0	45
Total	**350**	**25**	**325**	**200**	**50**	**75**

Source: IASB, Citi Research

The disclosure table in Figure 9 will be presented for both financial assets and financial liabilities. Column (a) is the gross position, and column (b) the amounts offset on balance sheet. Column (b) will differ for a US GAAP company vs. an IFRS company due to the differences in offsetting rules, with column (c) being gross amounts minus offset amounts, ie the balance sheet amount. Comparing columns (a) and (c) will enable investors to better understand the extent to which offsetting reduces reported leverage.

Column (d) presents the related financial instruments and collateral which have not been offset in the balance sheet as they do not meet all of the criteria to be eligible for offset in the balance sheet. Column (e) is difference between column (c) and

[9] See www.fasb.org, 26 November 2012.

columns (d), and is the "net net" asset or liability. This is net of all related amounts of financial instruments and collateral, whether or not such amounts are permitted to be offset under the accounting rules applied.

There is an alternative requirement, which provides the same gross to net analysis, but with columns (c) through (e) in Figure 9 split by counterparty rather than instrument type. This is as presented in Figure 10. Counterparties will not be named but all individually significant counterparties must be separately disclosed.

Figure 10. Alternative disclosure tables – split gross to net reconciliation

	(a)	(b)	(c) = (a) – (b)
Description	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off on the balance sheet	Net amounts of recognised financial assets on the balance sheet
Derivatives	100	20	80
Repos	200	0	200
Other	50	5	45
Total	**350**	**25**	**325**

	(c)	(d)		(e) = (c) – (d)
Counterparty	Net amounts of recognised financial assets on the balance sheet	Related amounts not set off in the balance sheet		Net amount
		Financial instruments	Cash collateral received	
Counterparty A	163	100	25	38
Counterparty B	98	60	15	23
Other	65	40	10	15
Total	**325**	**200**	**50**	**75**

Source: IASB, Citi Research

There will also be a qualitative disclosure requirement to provide a description of the rights provided by MNAs and similar agreements associated with the figures included in columns (d).

The new disclosures are mandatory from Q1/H1 2013[10].

Other Issues affecting Balance Sheet Comparability

Differences on consolidation and derecognition may also distort comparisons, but impact not quantifiable and unlikely to be significant

Offsetting rules may not be the only accounting issue affecting comparability of US and European banks' balance sheets. Bank leverage ratios could also be affected by differences in Consolidation rules and Derecognition rules, which we discuss further below. We are unable to quantify the impact of these differences, but based on conversations with industry experts we do not think that leverage comparisons are significantly distorted in consequence.

Finally, we note that other accounting rules may affect the calculation of shareholders' equity and therefore affect the denominator of the leverage ratio. For example, at present IFRS accounting allows off balance sheet treatment of some pension gains/losses, whereas US GAAP does not. Some European banks make use of this accounting choice, presumably because it flatters their book value. However, from 2013 IFRS will require pension deficits to be on balance sheet.

Consolidation rules

Consolidation rules dictate which entities are included within the consolidated financial statements and which are "off balance sheet". Both IFRS and US GAAP have general consolidation guidance (eg at which level of control/shareholding a subsidiary should be consolidated) and specific rules relating to special purposes entities (SPEs).

[10] IFRS 7 (Financial Instruments – Disclosures) specifies the required disclosures in paragraphs 13A-13F, while paragraph 44R states that these apply for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods.

US GAAP was criticized during the global financial crisis due to weaknesses on the rules relating to SPEs, which were commonly used in securitization structures. At the time, US GAAP contained specific quantitative tests to determine whether certain SPEs should be consolidated. It was common for banks to construct SPEs which would meet these quantitative tests and therefore qualify for off-balance sheet treatment. However, these US GAAP rules were replaced with effect from 2010 financial year onwards. Under the new guidance, which prioritises qualitative testing, we believe it is harder for banks to achieve off-balance sheet treatment for special purpose vehicles.

The IFRS guidance on SPEs (SIC 12) relies on qualitative assessment of the "risks and rewards" of the structure and was generally considered to be less open to abuse than the US GAAP guidance during the financial crisis. Although not identical to current US GAAP, we do not expect major differences in practice in the exposure to off-balance sheet entities. In 2014[11] SIC 12 and other consolidation rules will be replaced by IFRS 10, but we do not expect this to have a major impact on consolidation of SPEs.

More generally, US GAAP guidance on consolidation follows a legal approach (eg consolidation based on majority of voting rights) whereas IFRS takes an arguably more principles-based approach focused on the practical ability to control even if less than half the voting rights are held. This may result in some subsidiaries being consolidated under IFRS that would not be under US GAAP, but we do not expect this will cause a major bias when comparing US and European banks balance sheets.

Derecognition rules

Derecognition rules relate to when a financial instrument can be removed from the balance sheet, eg when a financial asset may be treated as sold. US GAAP and IFRS take slightly different approaches. US GAAP focuses on when effective control over the financial asset has been surrendered, whereas IFRS focuses on the transfer of the risks and rewards arising from the asset. Although the accounting standards differ, we do not think comparisons of US and European banks' balance sheets are greatly distorted as a result.

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[11] For EU listed companies. 2013 effective date for other IFRS reporting companies.

Appendix A-1

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