Balance Sheet Netting for Eurex Repo Euro Market Transactions

Repo transactions are "on balance sheet" products. This means that positions from one or more repo/reverse repo transactions must be reflected on the bank's balance sheet as of the balance sheet date.

In accounting for financial/banking groups, a distinction is made in reporting between the single-entity financial statements of a group affiliate bank and the group's consolidated financial statements. In accordance with Regulation (EC) No. 1606/2002 dated July 19, 2002 (IAS Regulation), publicly traded companies must prepare their consolidated financial statements in accordance with IFRS with effect from 2005. Non-publicly traded companies have a choice and may opt for exempting consolidated financial statements in accordance with IFRS.

However, for national supervisory authorities (for example German Federal Financial Supervisory Authority – BaFin/German Bundesbank; UK Financial Services Authority – FSA/Bank of England) and for the purpose of, for example, calculating dividend distribution, the information in the single-entity financial statements is relevant. In Germany, single-entity financial statements must be prepared in accordance with the German Commercial Code (Handelsgesetzbuch – HGB); however the German Accounting Law Reform Act (Bilanzrechtsformgesetz – BilReG) offers large corporations the option of preparing single-entity financial statements in accordance with IFRS instead of the traditional method of preparation in accordance with HGB for their mandatory publications.

Significance of Consolidated Financial Statements

Uniform preparation of IFRS/IAS consolidated financial statements enables financial market players to reliably compare the economic performance of listed companies from different jurisdictions. During the sustained financial market crisis, supervisory authorities and governments showed increasing interest in measuring and managing financial market risks at an international level. Thus, international consolidated financial statements also increasingly became an object of "global" financial market supervision.

At present, as part of the general consolidation and stabilization activities on the financial markets, the absolute total on a consolidated balance sheet is very strictly and defensively managed. The degree to which the financial instruments impact consolidated financial statements will become a further direct key indicator for managing banks' trading and financing desks. In this context, the focus is on opportunities inherent in IFRS/IAS to offset opposing cash flows against each other for the purpose of a net accounting presentation. By netting cash inflows against cash outflows with matching risk profiles, banks meet the requirement to focus on the actual economic risk as reflected in the financial statement.

Accounting for Repo Transactions

IAS 32 section 42 sets forth the basic requirements for offsetting financial receivables and liabilities for consolidated financial statements prepared in accordance with IFRS. This section states that "a financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when and only when, an entity:

a) currently has a legally enforceable right to set off the recognised amounts; and
b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously."[1]

[1] Commission Regulation (EC) No 1126/2008 dated November 3, 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council.

In practical terms, this means that a corresponding legal agreement between the repo counterparties to offset repo and reverse repo transactions must be in effect and that appropriate structures for normal business operations have been established and are used.

The option of offsetting receivables and liabilities is also subject to transaction-specific requirements in addition to the basic requirements concerning the legal organizational framework cited. In other words, only financial transactions with similar risk profiles can be offset against each other. In practical implementation, this results in various congruence and identity requirements for the receivables and liabilities to be offset:

- Matching receivables/liabilities
- Matching currencies
- Matching maturities
- Simultaneous recording of performance
- Counterparty identity

The congruence and identity requirements are to be met to the same degree.

A brief interpretation of the requirements described follows.

Matching Receivables/Liabilities
Reference to IAS 39 sections 20 and 17 must be made in determining which repo transactions can in fact be offset against each other.

IAS 39 section 20: "When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In such case, the following applies: (…)
c) If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset."

IAS 39 section 17: "An entity shall derecognise a financial asset when, and only when:
a) the contractual rights to the cash flows from the financial asset expire; (…)." [1]

As the repo transaction's economic motive is to establish a risk-neutral loan by means of collateralizing and pricing, the financial claims and economic risks generally remain with the collateral provider. Thus the established repo master agreements provide for transfering (reconveyance) of all claims on cash flows from securities transferred from the collateral recipient to the benefit of the collateral provider. Thus the collateral recipient only recognizes a claim in cash and the collateral provider a liability in cash. The underlying collateral (securities) remain recognized on the collateral provider's balance sheet, but "off" the collateral provider's balance they are called assets (securities) used to collateralize a loan/liability.

In other words, using a security in a repo transaction does not change its allocation and presentation on the collateral provider's balance sheet. The effect of a repo transaction on the balance sheet is limited to the recognition of the associated receivables and liabilities in cash (actual cash amount/loan amount and repo interest/loan interest).

Consequently, repo and reverse repo transactions are netted for the balance sheet presentation by the receivables and liabilities in cash being offset to a single netted amount.[2]

[1] Commission Regulation (EC) No 1126/2008 dated November 3, 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council.

[2] Balance sheet recognition of repo transactions (securities), among other things, is currently the subject of discussion by the IASB in a public consultation process. Potential changes in accounting requirements for repo securities that have been transferred may also directly affect the option of offsetting repo transactions.

Matching Currencies

As cash amounts are included in the balance sheet presentation and netting of repo transactions, transactions can only be offset against each other whose cash amounts (actual cash amount/loan amount and repo interest/loan interest) are denominated in the same currency.

Matching Maturities

Maturity is a key parameter in both general lending business and in the repo business. The residual maturity of a repo transaction as at balance sheet date is the relevant maturity factor in presenting the financial position and earnings situation and in the approach and valuation of a repo transaction.

For this reason, in practice, only repo and reverse repo transactions with the same final maturity (performance date and settlement date of the term leg) are offset against each other.

Simultaneous Recording of Performance

The functional operational requirement for "simultaneous settlement" (clearing/settlement) of receivables and liabilities as a basic condition for netted presentation on an IFRS balance sheet is, in practice, interpreted as meaning

a) the receivables and liabilities to be netted are satisfied by settlement of a netted receivable/liability, or

b) the receivables and liabilities to be netted are satisfied by recognition of simultaneous settlement routines.

See also IAS 32 section 48 concerning this: "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. 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."[3]

Counterparty Identity

Only such repo and reverse repo transactions that have been concluded with the same counterparty can be offset against each other.

Accounting for Eurex Repo Transactions

The following applies to transactions of Eurex Repo GmbH (Eurex Repo Euro Market):

- Eurex Repo Market transactions are without exception repo transactions.
- Eurex Clearing acts as a central clearing house for all Eurex Repo Market transactions.
- Eurex Repo Euro Market transactions of clearing members are concluded exclusively with Eurex Clearing AG as central counterparty.[4]

Thus, in principle, all Eurex Repo Euro Market transactions qualify for balance sheet netting in accordance with IFRS/IAS section 42.

The practice observed among Eurex Repo Euro Market participants follows this approach and nets all expected cash flows with identical final maturity from all outstanding Eurex Repo repo and reverse repo transactions (Special, Classic GC Repo, GC Pooling® transactions) in the consolidated financial statements in accordance with IFRS/IAS.

[3] Commission Regulation (EC) No 1126/2008 dated November 3, 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council.

[4] Exception: Non-Clearing Members conclude repo transactions exclusively with their General Clearing Member.

Requirements for Balance Sheet Netting

IFRS requirements	Eurex Repo/Eurex Clearing policy
Defined genuine repurchase agreement (repo transaction)	Eurex Repo, Terms and Conditions, section 3, p.12 et. seq.
Defined central counterparty	Eurex Repo, Terms and Conditions, section 1, para. 1.3 (1)
Defined relevant clearing conditions	Eurex Repo, Terms and Conditions, section 1, para. 1.4 Eurex Clearing, Clearing Conditions, section IV, para. 2.1 (2)
Defined netting agreement	Eurex Clearing, Clearing Conditions, section 1, para. 1.4 et. seq.
Defined central clearing house and simultaneous settlement	Eurex Clearing, Clearing Conditions, section 1, para. 1.5 et. seq.

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