CEBS Comment Letter on ED 7

CEBS welcomes the opportunity to comment on this exposure draft on disclosures of financial instruments. Banking supervisors regard market discipline as an important tool to promote international financial stability and to enhance the soundness of the financial system. As such, they are contributing to international efforts in enhancing public disclosures and transparency in banking activities as well as in financial markets.

These efforts have materialised in particular in comprehensive requirements on market discipline, developed as *pillar 3* of the 'International Convergence of Capital Measurement and Capital Standards: a Revised Framework' commonly referred to as Basel II, published by the Basel Committee on Banking Supervision in June 2004. These provisions are in the process of being implemented in the European Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions.

Pursuant to this objective, banking supervisors have a strong interest in the development of sound accounting provisions on public disclosures. CEBS commends the IASB for its efforts in that respect and, in particular, for its decision to replace IAS 30 by a more risk-focused standard, consistent with current risk management practices and *pillar 3* requirements.

For clarity reasons, some important comments are placed in the 'general comments' section of this letter although they relate also to the questions asked in the Invitation to Comment of the Exposure Draft. Specific answers to questions 1 to 9 of the exposure draft follow the 'general comments' section.

The comments provided herewith do refer only to banking supervision concerns on financial disclosures requirements, irrespective of the security regulations which are dealt with in other European forums.

General Comments

Scope of the standard and level of detail

CEBS welcomes the regrouping of disclosure provisions displayed currently in IAS 30 and in IAS 32 in a single standard. We acknowledge that, contrary to IAS 30, the proposed standard will not be specific to the banking industry. We also recognise that the proposed standard will provide a certain degree of flexibility for the management in determining the adequate level of disclosure.

Given the significance of financial instruments in banking activities, banking supervisors will expect, however, a high degree of disclosure from credit institutions, consistent with *pillar 3* requirements. Furthermore, we believe that the minimum requirements defined in this exposure draft could be made more precise in some areas, without excessive burden on the entities. Further comments in that respect are detailed in the answer to question 1.

We noted the proposed inclusion of small and medium entities –SME- in the scope of the standard. CEBS agrees with this approach, as some banking institutions might qualify as SME. In addition we regard also as essential that banking institutions, which are among the most prominent users of financial statements of SME, be in a position to assess and monitor closely the risks arising from the use of financial instruments by this category of customers. We are confident that the flexibility offered by the proposed standard should guard against excessive reporting burdens for SME, provided that they do not use financial instruments intensively.

Disclosure of 'pillar 2' capital requirements

CEBS commends the IASB for its approach towards externally imposed capital requirements for regulated entities, on the basis of the rationale developed in BC 52. In particular, we strongly support the proposed exemption of disclosure for 'pillar 2' –individual/entity specific-capital requirements, as defined in the same Basel Committee document mentioned above. Doing otherwise would not improve comparability across regulated entities and would have undesirable, suboptimal consequences, as supervisors might refrain from using a communication tool with the regulated entities which provides at the same time for clarity and confidentiality in the process. In most jurisdictions, 'pillar 2' capital requirements will remain confidential between regulated entities and their supervisors, and 'pillar 3' requirements do not provide for a disclosure of 'pillar 2' capital requirements.

In that respect, CEBS recommends to clarify that paragraphs 47(d) and 47(e) of the proposed standard do not apply to externally imposed entity-specific capital requirements (see also our answer to question 8). It has to be noted that the definition of capital referred to in paragraph 47(d) is not based on accounting numbers but on prudential definitions and that the determination of an entity specific capital requirement is based generally on highly sensitive information and extensive discussions between the regulated entity and its supervisor. Moreover, the entity-specific nature of 'pillar 2' implies that it is up to the supervisor to decide ultimately whether there is a breach of the requirement or not. Hence, the disclosure of a breach of 'pillar 2' capital requirement by an entity might be misleading in some cases, being out of context.

Structure of disclosures

The Exposure draft requires disclosures of carrying amounts by portfolios according to IAS 39, whereas IAS 1 requires a balance sheet to be structured by liquidity. We welcome the introduction of a portfolio approach, which seems to better reflect the nature of risks taken by financial institutions and, from a general point of view, by institutions which make a broad use of financial instruments. However, we would suggest additional guidance on the link between IAS 1 and the provisions of this exposure draft.

Disclosure of the use of the fair value option

In case the IASB would maintain the possibility to apply the fair value option to financial instruments, CEBS recommends a more detailed disclosure on the use of the option, in order to allow precise assessment of the impact by users of the financial statements. In particular, we regard as essential that users of financial statements be in a position to assess the effect of fair valuing their own credit risk by the entities using the option:

- we would welcome clarification about whether paragraphs 11 and 23(a) apply only to the fair value option or to *held for trading* instruments also. In that case, the disclosure requirements should apply separately;
- paragraphs 11 and 12 of the proposed standard do not allow necessarily precise identification of the amount of change in fair value due to a change in credit risk, as the fair value of some structured issues may be composed of different elements (for example

when they contain embedded derivative whose fair value depends on an equity market index); we believe that the amount of change in the fair value of a financial liability due to a change of the own credit risk of the issuer should be disclosed in any case, both the cumulative effect and the relevant amount for the period.

Other fair value requirements

In order to complement the proposed qualitative requirements set out in paragraph 31(b) of the exposure draft, we recommend to disclose the percentage of each class of financial assets and financial liabilities whose fair value is determined by reference to published price quotations in an active market or is estimated using a valuation technique. We believe this is important information to assess the reliability of the fair values disclosed by the entities.

We would welcome also a clarification of the meaning 'in full or in part' in paragraph 31(b) and 31(c), to make clearer whether it applies to separate components of individual financial instruments or to different classes of instruments.

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance.

The following suggestions are more detailed questions and often ask for clarification.

- The scope of the proposed standard (paragraphs 4 and 7) should clarify which types of financial instruments are considered to be unrecognised *financial instruments* (out of the scope of IAS 39 but within the scope of the proposed standard).
- The definition of 'classes' of financial instruments does not seem completely clear at the moment (paragraph 7 of the proposed standard). We would welcome more guidance on the implementation of this paragraph, in order to improve comparability across entities. An entity should also be required to disclose how and why it built different classes of financial instruments.
- Paragraph 13 requires disclosure of whether an entity has reclassified a financial asset as one measured at cost (or amortised cost) rather than at fair value. We recommend to add a similar disclosure requirement for instruments previously measured at cost (or amortised cost) and remeasured as at fair value or previously classified as held to maturity and reclassified as available for sale. The reason of such reclassification should be included also.
- Paragraph 14 requires certain disclosures for securitised assets when they do not qualify for a transfer. CEBS believes that the total amount of securitised assets which qualify for a transfer could also be disclosed. We regard the total amount of securitised assets –distinguishing between those which qualify or not for a transfer- as interesting information for the market. This requirement would not extend to all derecognised assets, to maintain relevance of the information disclosed and avoid unnecessary reporting burdens.
- We regard adequate disclosures on credit risk as elements of paramount importance for users of financial statements of banking institutions. In that respect, we welcome the provisions of the proposed standard, which will ensure consistency with 'pillar 3' requirements. However, we would welcome more detailed minimum requirements regarding disclosures of impaired assets -paragraph 40(b)- and impairment losses -paragraphs 17 and 22-. We believe in particular that disclosure requirements should make a clear distinction between individual and collective impairment (see also our answer to question 8).
- Disclosures requirements of IAS 30 are more precise for accounting policies concerning contingencies and commitments. We would welcome a disclosure requirement for accounting policies concerning contingencies and commitments in the proposed exposure draft, in particular for guarantees issued and received.

- Liquidity risk disclosure requirements in paragraph 42(a) no longer apply to both assets and liabilities, contrary to IAS 30. We believe that liquidity risk disclosures limited to liabilities only are not sufficient for users of financial statements and we would welcome disclosure requirements concerning liquidity risks for assets also, as the assessment of the liquidity risk of an entity is only possible by assessing the liquidity of both sides of the balance sheet simultaneously.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements.

CEBS welcomes the proposed provisions of the exposure draft but noted that paragraphs 80 and 81 of IAS 32 currently require to provide for the description and effect of netting and master netting settlement agreements. This information is not required anymore in the proposed standard. We recommend to add it back (description of existence and effect).

We would like to mention also that a comparison between a class of financial instruments and the total fair value of the collateral obtained for that class of financial instruments might be misleading in some way, as a collateral might not be transferable on other instruments of the same class, even if its fair value is bigger than the one of the instrument it covers.

Question 3 – Disclosure of a sensitivity analysis.

CEBS welcomes the proposed disclosure of a sensitivity analysis for all entities, as well as the related implementation guidance. It has to be noted however that such information might not be sufficient -and might even be misleading in certain situations-, depending on the complexity and risk factors of the financial instruments involved in the operations. Hence, we consider that this type of disclosure should be regarded only as a minimum (as displayed in paragraph 45). The implementation guidance provides for useful examples in that respect (in particular the distinction between held for trading and other categories of financial instruments).

CEBS would suggest complementing the implementation guidance with an example relating to the distinction between operating strategies: e.g. in the case of banking institutions, the need to provide a sensitivity analysis for ‘trading book’ and ‘banking book’ operations separately, as these two kinds of strategies are usually managed in different ways.

Question 4 – Capital disclosures.

CEBS answer to this question is provided in the ‘general comments’ section of this letter (disclosure of ‘pillar 2’ capital requirements). Please refer also to our answer to question 8.

Question 5 – Effective date and transition.

CEBS agrees with the proposed exemption for early adopters. We supposed that IAS 30 will cease to apply at the same time that an entity applies the provisions of the proposed exposure draft.

Question 6 – Location of disclosures of risks arising from financial instruments.

CEBS agrees that disclosures of risks arising from financial instruments should be part of the financial statements, as it will ensure, in most jurisdictions, a higher degree of reliability of the information disclosed, through regular external audit of these financial statements.

However it has to be noted that a significant part of the disclosures proposed in the exposure draft will not be of a pure accounting nature -e.g. proposed disclosure of a sensitivity analysis- and will include some elements provided by management information systems. It

should be noted also that ‘Pillar 3’ requirements do not provide for a specific location of the information disclosed, as long as its accuracy and reliability are verified (but not necessarily audited). As a matter of fact, some of the information required by Pillar 3 provisions might be inconsistent in some way with IASB accounting standards. Moreover, some banking institutions often provide information to the market on a voluntary basis. It would follow that, depending on the location of the information, the comprehensiveness of the audit procedure might vary in some jurisdictions.

We would like to point out also that market participants often tend to focus only on very specific parts of the disclosures provided to them, depending on the communication policy of the corresponding entity, and that excessive detail and lack of structure in the way the information is provided might sometimes have misleading effects.

Hence, CEBS would recommend that more guidance is given about the location of the information provided, concerning in particular the distinction between Management discussion and analysis and Financial statements –the latter including the balance sheet, the profit and loss account and accompanying notes-.

Question 7 – Consequential amendments to IFRS 4.

CEBS supports the consequential amendments to IFRS 4, in order to ensure consistency with the provisions applying to disclosures on financial instruments, in particular for qualitative requirements. We believe it is important that users of financial statements of insurance companies have the opportunity to assess risks arising from insurance contracts and financial instruments on a coherent basis, without having to wait for the outcome of the ‘phase 2’ insurance accounting project of the IASB. Consistency across disclosure requirements is important also for the analysis of financial conglomerates.

Question 8 – Implementation Guidance.

CEBS welcomes the implementation guidance in general.

However, we strongly recommend to clarify that ‘Illustrative Example 2’ does not apply to entity specific capital requirements, for the reasons indicated in the ‘general comments’ section (disclosure of ‘pillar 2’ capital requirements) of this letter.

We have otherwise some improvement suggestions:

- IG 23 should make clear that the requirements of paragraph 40(b) apply separately to individual impairment and collective impairment (see our answer in question 1).
- IG 25 states that liabilities should be included in the earliest time band corresponding to the earliest possible redemption. We fear that such a presentation might be misleading, at least for financial instruments which would give rise to an early withdrawal penalty.
- We recommend to add the following item in IG 29:
  IG 29(x) expects that some (or a portion) of its loan commitments will not be drawn.

Question 9 – Differences from the Exposure draft *Fair Value Measurements* published by the US FASB.

CEBS agrees with ED7 proposed disclosure of information about the use of fair value in measuring assets and liabilities, except for financial instruments designated as at fair value through profit or loss on initial recognition. We would like also to reinforce the quantitative requirements about the use of fair value. Please refer to the ‘general comments’ section of this letter (‘use of the fair value option’ and ‘other fair value requirements’).

Question 10 – Other Comments.

CEBS has no other comment, save the comments provided in the 'general comments' section of this letter.