Committee of European Banking Supervisors

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International Accounting Standards Board
30 Cannon Street,
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Dear Madam, dear Sir

Exposure Draft Improving Disclosures about Financial Instruments (Proposed Amendments to IFRS 7)

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the Exposure Draft Improving Disclosures about Financial Instruments.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

CEBS regards disclosures about financial instruments in particular to be an important contributing factor to ensuring that users of financial statements can make well-informed investment decisions. Decision-relevant disclosure should also result in better transparency and thus strengthen market discipline mechanisms, which supervisors regard as an important tool to promote international financial stability and to enhance the soundness of the financial system.

With this in mind CEBS welcomes the exposure draft with proposed amendments to IFRS 7, though there are some aspects which we consider could be taken further. These issues are addressed in more detail in the appendix.

The comments put forward in this letter and the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Subgroup on Accounting under the direction of Mr. Ian Michael of the UK FSA. If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) or Mr. Michael (+ 44.20.7066.7098).

Yours sincerely,

Kerstin af Jochnick
Chair, Committee of European Banking Supervisors

Appendix

General Comments

As set out in the cover letter, CEBS welcomes the exposure draft with proposed amendments to IFRS 7. In particular CEBS acknowledges that the proposals aim to enhance disclosures about fair value measurements and the liquidity risk of financial instruments.

Fair value measurement disclosures

While CEBS welcomes the amendments introduced by the ED to fair value disclosures, it is also of the view that the proposals in some areas are not far-reaching enough. This relates in particular to disclosures regarding the control environment and governance over valuation processes.

We appreciate that the IASB Expert Advisory Panel's guidance 'Measuring and disclosing the fair value of financial instruments in markets that are no longer active' addresses these and other disclosure issues in more detail.

They have also been addressed in CEBS June 2008 report where the IASB is encouraged to '… review IFRS 7 in the light of the current developments and consider … quantitative disclosures, on stress scenarios reflecting the sensitivity and uncertainty of valuations'. In addition CEBS encourages institutions to enhance their disclosures on fair values and on valuation techniques by providing information on valuation processes - including assumptions and input factors institutions use - as well as adjustments applied to reflect model risk and other valuation uncertainties, and information on the extent of those uncertainties.

CEBS encourages the IASB to consider more fully how these issues and the Expert Advisory Panel's guidance can be incorporated in the final amendments to IFRS 7.[1] An important aspect of the guidance which CEBS recommends be incorporated into IFRS 7 is disclosure of <u>how</u> any change in the fair value of liabilities attributed to 'own credit risk' has been calculated (c.f. IFRS 7 10 [a]).

Liquidity risk disclosures

CEBS is also of the opinion that the proposed amendments with regard to the liquidity risk disclosures should be expanded, as the proposals are not as demanding for assets (and off balance sheet items) as they are for liabilities. Thus, even if the proposals are viewed as a positive step, the required information will not necessarily facilitate a reasonable understanding of the liquidity risk profile of financial institutions (to the extent that some information is missing on the asset side, or regarding contingent claims, guarantees, etc.).[2]

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[1] The CEBS Report on issues regarding the valuation of complex and illiquid financial instruments (18 June 2008) can be accessed at: http://www.c-ebs.org/getdoc/649c4608-bf93-486c-b832-5dc4426d0e51/20080618b_valuation.aspx . Annex 1 contains an overview of the issues raised with respect to fair value measurement related disclosures.

[2] The comments made in the advice CEBS issued to the European Commission on liquidity risk management remain fully relevant. The Advice is available at http://www.c-ebs.org/Publications/Advice/2008/CEBS'S-TECHNICAL-ADVICE-ON-LIQUIDITY-RISK-MANAGEME.aspx . An excerpt of the advice dealing more particularly with disclosures has been included in an annex

A reasonably complete quantitative insight into the liquidity risk exposure of banks is not really possible without a comprehensive stressed view on the asset and liabilities structure, including collateral rights and obligations and including off-balance-sheet items and currency mismatches in the most important currencies. However, CEBS acknowledges that IFRS 7 is not designed specifically for banks, and therefore such disclosures might more appropriately be included in Basel/CRD Pillar III.

Specific comments

Question 1

Do you agree with the proposal in paragraph 27A to require entities to disclose the fair value of financial instruments using a fair value hierarchy? If not, why?

CEBS agrees with the introduction of a requirement asking entities to disclose the fair value of financial instruments using a fair value hierarchy (question 1), which is in line with an issue CEBS put forward in its June 2008 Report on issues regarding the valuation of complex and illiquid financial instruments. In the report CEBS more specifically encourages:

> *'[T]he IASB to review IFRS 7 in the light of the current developments and consider in particular the incorporation of quantitative disclosures on fair values determined under each of the different levels of the fair value hierarchy ...'*

CEBS considers that disclosures according to an explicit fair value hierarchy as introduced in new 27A is particularly helpful in achieving greater comparability and consistency between institutions.

Question 2

Do you agree with the three-level fair value hierarchy as set out in paragraph 27A? If not, why? What would you propose instead, and why?

At the same time CEBS is of the view that the IASB must ensure that the final hierarchy unambiguously reflects the different levels of fair value measurement as included in IAS 39 and does not indirectly introduce concepts and practices stemming from the US GAAP standard FAS 157, without undertaking full due process on how any differences between the relevant international and US accounting standards should be addressed.

Question 3

Do you agree with the proposals in:

(a) paragraph 27B ...

(b) paragraph 27C ...

With regard to 27B and in particular for 27B (b) and (c) the disclosures should not be limited only to Level 3 fair values. At a minimum the IASB should consider extending the disclosures under these points to Level 2 fair values, to allow for a better understanding of the importance of the different Levels of fair value as well as related unrealised gains and losses for the period

In general, CEBS agrees with paragraph 27C. The IASB might consider whether that information should also be presented in tabular format, as requested in the Implementation Guidance (IG 13A and 13B) for paragraphs 27B(a) and (b).

Because the disclosures need to be quite granular to be meaningful, CEBS considers that information about levels of fair value should be provided not only for classes of financial instruments but also for accounting (IAS 39) categories (or accounting portfolios) because the impact on equity is different. This relates to a recommendation in the June 2008 CEBS report on valuation issues which suggested that institutions enhance their disclosures on fair values and on valuation techniques 'by providing information on the fair value hierarchy, ... with a breakdown between cash and derivative instruments and disclosures on migrations between the different levels'. It is suggested that the IASB considers including these additional disclosures in the final amendment to IFRS 7.

Furthermore, the IASB should ensure that there is consistency in the final amendments between the requirements in the standard and the implementation guidance which, in IG13A and B, seems to implement these requirements by making disclosures in terms of accounting categories (or portfolios).

Finally, we also suggest that the IASB considers extending the disclosures in paragraph 27B (c) to provide information about the accumulated amount of unrealized gains and losses for, at least, Level 2 and 3 fair values. It should be borne in mind that these accumulated fair value changes are recognised in profit or loss, other comprehensive income or retained earnings (those generated in previous periods) and, consequently, this information would allow assessment, to certain extent, of the 'quality' of the aforementioned components of an entity's equity. For example, some users may consider that gains or losses on Level 3 items included within retained earnings to be of lower 'quality' (in terms for example of reliability and information content generally) than others.

Liquidity risk disclosures

Question 4

Do you agree with the proposal in paragraph 39(a) to require entities to disclose a maturity analysis for derivative financial liabilities based on how the entity manages the liquidity risk associated with such instruments? If not, why? What would you propose instead, and why?

Yes, subject to inclusion of a requirement for a fully adequate explanation of this management (in paragraph 39 (c)), this proposal is appropriate.

CEBS also considers that for banks information about funding diversification is relevant, as is the extent to which that funding depends on wholesale funding (whether short term or otherwise) or retail funding. Disclosures about this type of funding should be one integral element of the application guidance in B11 E (c).

Question 5

Do you agree with the proposal in paragraph 39(b) to require entities to disclose a maturity analysis for non-derivative financial liabilities based on remaining expected maturities if the entity manages the liquidity risk associated with such instruments on the basis of expected maturities? If not, why? What would you propose instead, and why?

We agree that behavioural (expected) maturities should be used in instances when an entity manages liquidity risk on that basis, provided an adequate explanation of how these are determined is given (in the context of 39 (c)), in addition to the disclosure of remaining contractual maturities.

Question 6

Do you agree with the amended definition of liquidity risk in Appendix A? If not, how would you define liquidity risk, and why?

Yes, some obligations can be settled by delivering other financial assets. It may also prove useful to clarify that the liquidity risk materialises not only when the commitments cannot be met but also when meeting these commitments cannot be achieved "at reasonable cost". This could be done by adding "at a reasonable cost" at the very end of the proposed definition.

Effective date and transition

Question 7

Do you agree with the proposed effective date? If not, why? What would you propose instead, and why?

Yes.

Question 8

Are the transition requirements appropriate? If not, why? What would you propose instead, and why?

Yes.

Annex 1 – Excerpt from the CEBS report on Valuation isses

IV.2. Transparency on valuation practices and methodologies as well as related uncertainty

60. Disclosures are generally accepted to be a key contributor to market discipline and market confidence. The issues raised in the following paragraphs should be considered in close conjunction with the report CEBS has prepared in parallel to assess banks' transparency with regard to activities and products affected by the market turmoil.[11]

Box 3
IFRS 7, which came into force on 1 January 2007, requires disclosure of the significance of financial instruments for an entity's financial position and performance as well as qualitative and quantitative information about exposure to risks arising from financial instruments. More specifically with respect to fair values and valuation techniques IFRS 7 contains a number of requirements for disclosures that an institution has to make.[12]

61. While the current disclosure requirements with regard to fair values and valuation techniques are rather substantial, CEBS's analysis of current disclosures shows that there are important differences in terms of the level of detail of the disclosures and their presentation. CEBS acknowledges however that part of this heterogeneity is related to the fact that in many cases IFRS 7 has been applied for the first time.

[11] The CEBS report on 'banks' transparency on activities and products affected by the market turmoil' has been published on 18 June 2008 and can be accessed on CEBS's website at: http://www.c-ebs.org/press/20080618a.htm .

[12] In summary these cover the following disclosures:

- for each class of financial assets and financial liabilities, the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount;
- the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities;
- whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique;
- whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data;
- the total amount of the change in fair value estimated using such a valuation technique that was recognised in profit or loss during the period;
- if a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique exists, an entity shall disclose, by class of financial instrument its accounting policy for recognising that difference in profit or loss; and the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

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62. Moreover, it was noted that the level and content of disclosure requirements were different in IFRS 7 and in US GAAP.

63. The analysis showed that institutions provided a good deal of qualitative information on the valuation methods, on the processes and on their use. At the same time the information that has been provided on the assumptions underlying the valuation techniques is scarcer.

64. As an example IFRS 7 makes it compulsory for an entity to disclose information about its assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. However, detailed information has only been provided in a limited number of cases.

65. Similarly, information on the type of adjustments applied to reflect model risk and other uncertainties was rather limited and, where provided, rather generic.

66. There is a need for institutions and market participants to improve their communication on the impacts of fair valuation (both negative and positive) as well as on the uncertainties it implies. For key material exposures, disclosures could incorporate for instance valuation ranges based on a variety of inputs and assumptions.

67. Obviously the disclosures reflect to some extent the differences that can be observed in terms of valuation practices among institutions and which have been discussed in earlier parts of this report.

68. The following issues should not be considered exclusively in the context of the current market turmoil. They aim to contribute in the longer run to an improvement in institutions' disclosures on valuation related issues.

Issues to be addressed:

⇨ *Institutions to enhance their disclosures on fair values and on valuation techniques by providing information on:*

- *financial instruments to which fair values are applied;*
- *treatment of Day 1 profits (including quantitative information);*
- *use of the fair value option (including its conditions for use) and related amounts (with appropriate breakdowns);*
- *the fair value hierarchy, including a breakdown of all exposures measured at fair value by different levels of the fair value hierarchy, with a breakdown between cash and derivative instruments and disclosures on migrations between the different levels;*
- *a description of modelling techniques and of the instruments to which they are applied, in particular:*
    - *valuation processes, including the assumptions and input factors institutions use in modelling techniques;*
    - *the type of adjustments applied to reflect model risk and other valuation uncertainties;*
- *sensitivity of fair values; and*
- *stress scenarios.*

⇨ *The IASB to review IFRS 7 in the light of the current developments and consider in particular the incorporation of quantitative disclosures on fair values determined under each of the different levels of the fair value hierarchy, as well as quantitative disclosures on stress scenarios reflecting the sensitivity and uncertainty of valuations.*

Annex 2– Excerpt from CEBS's advice on liquidity risk management (Second part)

Transparency in compliance with IFRS 7

195- IFRS 7 applies to all risks arising from all financial instruments, including those instruments that are not recognised on the balance sheet, and to all types of listed entities that are required to prepare consolidated financial statements.

196- IFRS 7 is less prescriptive than IAS 30, in that it eliminates the requirement to disclose the contractual maturities of financial assets. Financial liabilities, however, must be disclosed by contractual maturity, based on undiscounted cash flows, according to the internal information available to the management. One of the difficulties in preparing this maturity analysis is the treatment of derivatives, which normally involve a series of cash flows. The guidance in IFRS 7 states that net amounts should be included in the analysis for pay float/receive fixed interest rate swaps for each contractual maturity category when only a net cash flow will be exchanged. Hence, a currency swap would need to be included in the maturity analysis based on gross cash flows.

197- IFRS 7 recommends time frames that may be used in preparing the contractual maturity analysis for liabilities. It also expands the disclosure of liquidity risk to include a description of how liquidity risks are managed.

198- IFRS 7 disclosures must be based on the accounting policies used for the financial statements prepared in accordance with IFRS, including consolidation adjustments. It is possible that the internal information made available to management for risk management purposes is not prepared under accounting policies. To fulfil IFRS 7, this information is accepted, especially for the description of how liquidity risks are managed.

Point of interest/ lesson 12

IFRS 7 is of limited relevance to the banking business, particularly given that only liabilities are required to be declared by contractual maturity.

199- Even though institutions are increasing their disclosures on liquidity at the group level, authorities usually do not impose any disclosure requirements beyond those of the accounting rules. Hence, there seems to be a market demand for institutions to increase the level of the liquidity information they disclose. The issue here is whether there should be supervisory pressure or a supervisory requirement to increase the current level of disclosure.

200- Although all banking business inherently generates liquidity risk, banks' liquidity risk management varies widely, depending on the business model, the main activities that are pursued, and many other features. Moreover, different institutions have different degrees of liquidity risk tolerance. All of these factors give rise to different liquidity needs and different liquidity approaches; hence a standardised approach to disclosure may fail to provide the right picture of each institution.