Committee of European Banking Supervisors

CEBS

October 2009

Consultation Paper 30

Disclosure guidelines : Lessons learnt from the financial crisis

Introduction

The recent financial market crisis has underlined that high quality disclosures are a critical component in maintaining market confidence. In such circumstances, financial institutions should provide timely and adequate information to enable users to assess their situation.

Based on the findings of CEBS's work assessing banks' disclosures in the wake of the publication of its list of good practices in June 2008 'Report on banks' transparency on activities and products affected by the recent market turmoil' CEBS decided to develop disclosure guidelines to reflect the lessons learnt from the financial crisis.

CEBS's work should help institutions fulfil the recommendations of the Financial Stability Forum (FSF) on transparency set out in its report "Enhancing market and institutional resilience" of April 2008 which aimed to enhance risk disclosures through drawing the lessons from the recent turmoil.

Objective

The CEBS's disclosure guidelines are intended to guide financial institutions in providing adequate public disclosures. While developed from observations made in the context of areas or activities under stress during the financial crisis, they should be useful in relation to any activities that warrant particular attention, irrespective of the economic environment.

CEBS's guidelines take the form of high-level principles and address both the form and content of disclosures. Indeed, while clear and robust disclosures are essential to informative and transparent financial reporting, the way that such disclosures are presented is particularly important in ensuring transparency.

CEBS's aim is to encourage enhanced quality of disclosures without amending, duplicating or adding to existing disclosure requirements, whether required under IFRS, Pillar 3, listing rules or any other disclosure requirements or recommendations institutions may be subject to.

This document is divided into three parts. The first part deals with the general principles that CEBS deems necessary to achieve high quality disclosures. The second part outlines the content of disclosures on areas or activities under stress. The third and last part provides guidance on presentational aspects.

I. GENERAL PRINCIPLES

1. Financial institutions should provide timely and up to date information irrespective of the timing of their normal publication calendar

Undue delay in the disclosure of information may affect its relevance. The sub-prime crisis emphasised the detrimental effects of communications which were not always – particularly in the early stages of the crisis - sufficiently timely. Financial institutions should therefore be alert to the need to provide timely information which means, when necessary, communicating outside their normal publication calendar. The frequency of the disclosures should be adapted to situations prone to rapid change.

2. In order to enhance the quality of information, financial institutions should provide adequate disclosures on areas of uncertainty

Disclosures must faithfully represent the underlying transactions and events. With areas of uncertainty, institutions should provide clear information on key estimates. CEBS also encourages institutions to make use of sensitivity analyses in areas of uncertainty. Well-explained sensitivity analyses, discussing their assumptions and the probabilities of the occurrence of various scenarios, allow users to form an opinion on the impact of a change in future expectations.

3. Financial institutions should provide comprehensive and meaningful information that fully describes their financial situation

To enable market participants to make a meaningful assessment of the situation, information should be comprehensive. Indeed, omissions can cause information to be misleading.

Given the heterogeneity of users of institutions' financial reporting, background information on the wider economic environment the institution operates in is necessary to provide sufficient information to understand the context for specific disclosures.

CEBS is aware that, particularly in stressed situations, some disclosures may be sensitive and may have a destabilising effect on an institution's position. In such cases, institutions should continue to comply with the disclosure obligations of the relevant reporting framework and contact, as appropriate, their competent authorities.

4. Disclosures should allow comparisons over time and between institutions

Comparability is an essential characteristic of useful information and is especially important in a period of turbulence. Therefore, financial institutions should strive to present their disclosures, as far as possible, in a way that facilitates comparability across institutions. Discussions in industry fora, standardised formats and possibly peer review appear very useful in this regard.

Financial institutions should also provide comparative information over time to allow users to monitor the evolution of their situations.

5. Financial institutions should seek to early adopt new disclosure standards and best practice recommendations from standard-setters and regulators

CEBS encourages financial institutions to adopt new disclosure standards and best practice recommendations from standard-setters and regulators as soon as possible, especially if these relate to activities that warrant particular attention. Where they do not take note of new guidance, institutions are encouraged to provide explanations as to why the new guidance has not been followed.

6. Financial institutions should specify whether and to what extent information has been verified by external auditors

Financial institutions should specify clearly what information is audited and what is not and, where relevant, whether it has been subject to a different level of assurance. Disclosures which are not audited should be reconciled to audited information whenever possible.

Additionally, financial institutions should ensure that information has been through adequate internal verification processes.

II. CONTENT

With the flexibility in terms of presentation offered by the existing disclosure requirements, the CEBS's disclosure guidelines provide an outline of how to organise the information. To this end, the disclosures are laid out under five headings:

- Business model;
- Impacts on results and risk exposures;
- Impacts on financial position;
- Risk management; and
- Sensitive accounting issues.

7. Financial institutions should elaborate on the position and importance of the activities under stress within their business model

Disclosures should cover:

- background information (to put the disclosures in context);
- an explanation of how activities contribute to an institution's value creation process;
- a description of the degree of involvement of an institution; and
- a discussion of the impact a stressed situation has had on the institution's strategy and objectives, including changes in business orientation or policies.

To understand an institution's overall risk profile, it is important to know why and to what extent the institution is engaged in activities that may have material adverse effects on its financial situation. The precise nature of the activities where difficulties have been encountered (or where they are likely to arise in the short-term) should be stated clearly. The information should be concise and focused.

In particular, it is important that institutions explain the significance of activities for their business, supported by sufficient forward-looking information.

Where the institution intends to adapt its business model or discontinue certain activities this should be clearly explained so users can understand the reasons behind the change of approach (or remedial measures) and its likely consequences.

8. Disclosures should include clear and accurate information regarding the impacts on results and on risk exposures of the activities under stress

Disclosures should cover:

- the precise nature of the risks incurred as well as the level of exposures related to its activities;
- detailed information on losses;
- the nature of the protection implemented or acquired to cover the risk and the quantitative impact of risk mitigation; and
- forward-looking information (institutions are encouraged to consider communicating information, possibly quantitative, that provides some insights into how the situation may evolve).

To allow readers to form a fair opinion of the risks incurred and the level of exposure, institutions are encouraged to present the information at an appropriate level of granularity (providing breakdowns by, for example, type of activities or instruments, geographical areas, business segments or credit quality, where relevant).

In the current crisis, it has appeared most useful for institutions to describe their exposures both before and after hedging, as well as for major instruments to provide notional and carrying amounts. This has provided a useful means to evaluate the impact of possible developments in the situation.

A clear and detailed description of the impacts of the activities under stress on the income statement is desirable to support a user's overall understanding of the institution's results.

The distinction between realised and unrealised losses is also extremely valuable to users, especially in a fair value environment. Indeed, while realised losses relate to transactions that have been completed, unrealised losses relate to on-going activities and may therefore be reversed.

Finally, forward-looking information is desirable and the institution should consider providing quantitative information on sensitivity analyses (using various scenarios). This provides useful information on the possible further write-downs that an institution could incur, in particular in the event of (persistently) difficult market conditions or, conversely, on the expected profits that could arise from an improved economic environment.

9. Disclosures should also include information regarding the impacts on the institution's financial position

Disclosures should cover:

- the impact of the activities in question on the level of capital and on the resulting solvency ratio; and
- the impact on the institution's liquidity position.

The protection offered by the level and quality of the institution's capital contributes significantly to market confidence.

The solvency ratio provides a kind of synthesis of an institution's financial situation since it reflects the changes in own funds and also any possible reassessment of risks in a deteriorating situation. Detailed disclosures are therefore needed to explain changes in the level of the solvency ratio due to the stressed situation and, in the extreme circumstances observed during the financial crisis, any recapitalisation measures taken to face it.

Also, institutions are expected to provide some detail of the impact on the institution's liquidity position. If quantitative data on liquidity is considered sensitive or detrimental to an institution's situation, there should be at least sufficient qualitative disclosures to give users an understanding of its position. The institution should also contact, as appropriate, its competent authorities

10. Financial institutions should communicate appropriately on the management of risks linked to activities under stress

Disclosures should cover:

- a description of relevant risk management practices, including associated governance arrangements where necessary; and
- a description of any measures taken to enhance risk management processes.

Institutions are urged to go beyond generic information on their processes for identifying, measuring, controlling and monitoring risks.

Institutions should include specific information on the risk management of the activities or instruments concerned such as specific valuation and reporting processes, results of sensitivity analyses or stress scenarios with clearly stated assumptions, effective operational limits and corrective measures underway to enhance those processes where necessary (including those decided after the reporting date).

11. Financial institutions should be as specific as possible with regard to sensitive accounting issues

Disclosures should cover:

- an adequate description of the accounting policies that are of particular relevance for the activities in question;
- details of relevant changes, if any; and
- detailed information where significant judgement has been applied.

Financial institutions are encouraged to highlight accounting policies that are of particular relevance for the areas or activities under stress. Such descriptions are most valuable when they focus on the specificities of the situation faced by the institution, rather than recycling generic descriptions.

Especially in a period of turbulence, when market confidence may be faltering, clear information on the management judgements affecting accounting figures is of the utmost importance since these can significantly affect the amounts recognised in the financial statements. For instance, judgement is called upon for fair values for financial instruments (especially when marking to model), impairment of financial and intangible assets and defined benefit pension schemes.

III. PRESENTATIONAL ISSUES

12. Disclosure should as far as possible be provided in one place with appropriate cross-references where necessary

While different presentation patterns are perfectly acceptable, CEBS is of the opinion that when specific events or situations have (or could have) significant adverse effects on the financial situation of the institution, these should be discussed in one particular section of the report or in a specific communiqué. Appropriate cross-references should clearly identify additional relevant information.

Institutions should also ensure that the information is easily accessible to all potential users.

13. Disclosure should be provided at an appropriate level of granularity to help achieve a high level of transparency

In considering an appropriate level of granularity for disclosure purposes, financial institutions should strive to disaggregate items which do not share similar characteristics, according to the focus of the disclosure being made. The information should be presented in a clear and transparent fashion, without resulting in information overload.

14. Financial institutions should seek an appropriate balance between quantitative information and narrative information

Generic (or “boilerplate”) disclosures which simply add to the quantity rather than quality of disclosure and fail to convey meaningful information should be avoided. There should be a healthy balance between quantitative and qualitative disclosures.

Using a tabular format (where possible) for quantitative information may be useful in providing clarity and supporting comparability across institutions. Associated narrative should add value to quantitative disclosures by way of analysis and interpretation. The use of illustrative tables and overviews is particularly helpful to guide the readers through the report.

15. Financial institutions should continue to develop an educational approach

Financial institutions should further develop an educational approach which aims to 'tell a story' about their activities – i.e. how the institution has performed and what its primary future risks are. Financial institutions should as far as possible use plain language, provide explanations of terminology (which can resolve possible ambiguity for the reader), use consistent terminology, and consider the inclusion of executive summaries in their disclosures.

16. Financial institutions which are not exposed to the activities under stress should clearly specify that fact when this is likely to provide useful information for users in their decision-making

Where financial institutions do not have significant exposure to activities under stress they are encouraged to disclose this to the market when this may not already be clear to users. An explicit mention of a low or non-existent level of involvement may be important information for users and is therefore desirable.