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Sandra Thompson
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Dear Ms Thompson

Exposure Draft ED 7 'Financial Instruments: Disclosures'

The Royal Bank of Scotland Group is one of the world's largest banks with shares listed on the London and New York Stock Exchanges. The Group's financial statements are prepared under UK GAAP and reconciled to US GAAP for its US filings. We support the introduction of IFRS and the aim of global harmonisation of accounting standards.

Nevertheless we have concerns that ED 7's proposals may not always result in the IASB's objectives being met. The exposure draft is aimed at all types of reporting entities without identifying the most important disclosures for each type. For example, the proposed disclosures concerning collateral are not universally applicable. As a bank we ensure that our advances to customers are appropriately secured. The valuation of collateral is a matter for commercial judgement and requires careful analysis to be meaningful – there is no merit in reporting, for example, the gross fair value of collateral as a proportion of gross advances.

Capital ratios and targets for a bank are a confidential matter for its Board and its Regulator. It would be inappropriate to publicise information except in broad terms, which might be suitable within management's commentary but not as part of the financial statements.

The proposed standard contains no exemptions for subsidiaries; we consider careful exemptions are essential in order to maintain the correct balance between the effort of preparing financial information and its usefulness.

There is one further matter that should be addressed: where the disclosures envisaged by the proposed standard should be made in the annual report. We suggest that only historical financial data should appear in the notes to the financial statements; matters that depend on the judgement and intent of the directors of the reporting entity should be included within management's commentary that falls outside the objective assessment of an audit report.

Our answers to your specific questions in the invitation to comment are attached as an appendix.

Yours sincerely

Rajan Kapoor
Group Chief Accountant

Appendix

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

The draft IFRS incorporates disclosures at present contained in IAS 32 *Financial Instruments: Disclosure and Presentation* so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).
(b) information about any allowance account (see paragraphs 17 and BC14).
(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).
(d) fee income and expense (see paragraphs 21(d) and BC17).

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

We believe the proposals are appropriate.

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

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28). Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

We do not favour the disclosure of the fair value of collateral. Typically banks will hold a very wide variety of collateral ranging from residential and commercial property to personal guarantees to fixed and floating charges over the undertakings of a business. Whilst the value of such collateral has to be assessed on a case by case basis in order to determine impairment, if any, determining the fair value of such a diverse range of assets would be a huge undertaking. Furthermore many elements would be stale by the time the information reached the public domain.

The simple disclosure of collateral provides no useful information to the user of financial statements. Useful data on collateral are likely to be costly to prepare and very extensive. The administrative burden of obtaining current fair values, for example for a large retail mortgage book is prohibitive. Similarly, providing the information proposed by paragraph 41 would be impractical and we are not convinced of the value of such disclosures.

We suggest that there should be narrative description of the nature of collateral pledged and sensitivity analysis around the impairment figure.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36-BC39). Is the proposed disclosure of a sensitivity analysis practicable for all entities? If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

No comment.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45-BC54). Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

We do not support the proposal to disclose in financial statements capital targets set by management. Disclosure of such measures may be appropriate in management's commentary as part of an integrated discussion of capital management but not in financial statements. It is not clear why the Board believes that such targets serve the purpose of financial statements – the structured presentation of the financial position and performance of the entity. We are also concerned by the requirement to discuss compliance with externally imposed capital requirements. Such capital requirements are confidential between the regulator and the regulated entity.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62-BC67). Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9). Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

We agree with the proposed effective date but request that the standard be explicit that early implementation would exempt a preparer from the disclosures in IAS 32 and IAS 30.

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

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements. Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

We do not agree that all the risk disclosures required by the exposure draft should be given in the financial statements. Many of these are qualitative and forward-looking and are more appropriately given in management's commentary rather than in audited financial statements. By their nature, such disclosures are not easily susceptible to audit without significant additional costs.

Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 *Insurance Contracts* to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57-BC61. Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

We agree in principle that the disclosures for insurers should be aligned with those for other businesses. There are factors that have to be taken into account in applying this principle:

- *The maturity date of an insurance liability depends on the occurrence of the insured event and other terms in the insurance contract such as any amount payable in the event that no claim is made.*
- *Insurers do not know when claims will crystallise, although they may be able to estimate of expected the maturities. As an alternative, insurers might disclose the expected earnings pattern of unearned premium.*

Paragraph 39(b)(iii) of IFRS 4 would be amended to read 'the amount of the risk exposure associated with all contracts…'. The amount of risk exposure from insurance contracts is not necessarily a good indicator of exposure because the maximum exposure is unlikely to represent the maximum possible loss. It might be better to omit the words 'the amount of' from the above paragraph so that insurers could provide information about their estimates of the exposure.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42-BC44). Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

It would be useful to have an example of the disclosures that the IASB envisages will be made by a financial institution because this should aid consistency of implementation.

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards *Fair Value Measurements* published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards *Fair Value Measurements*, which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:

(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities):

- (i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,
- (ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
- (iii) the effect of the remeasurements on earnings for the period (unrealised gains or losses) relating to those assets and liabilities still held at the reporting date.

(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of

- (i) the reason for remeasurements,
- (ii) the fair value amounts,
- (iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
- (iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.

Disclosures similar to (a) (ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a). Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

We would welcome harmonisation of disclosures between the proposed IFRS and the US standard, otherwise there will be duplication of effort by preparers and little benefit to users.

Question 10 – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

Scope of the exposure draft *– we strongly urge the Board to consider exempting subsidiaries and entity accounts of parent companies from, at a minimum, the risk disclosures requirements of the exposure draft. Such disclosures are very unlikely to be meaningful at this level.*

Very often the financial risks of a group are managed on a consolidated basis and therefore information relating to an individual subsidiary is naturally incomplete. The situation could be remedied by providing information relating to the group as a whole in the subsidiary's financial statements. Alternatively, the subsidiary could be exempted from disclosures proposed by ED 7 provided that it made explicit reference to the disclosures in a parent's financial statements and those statements were available to and could be understood by the users of the subsidiary's financial statements.

***Own credit risk** - we agree with the concept underlying paragraph 11 – disclosure of the amount of change in fair value of a financial liability, designated as at fair value through profit or loss, attributable to the change in the reporting entity's own credit risk. However, this paragraph and paragraph 12 result in disclosure of changes other than attributable to interest rates. As such they may include factors other than solely changes in the reporting entity's own credit risk in respect of liabilities with repayment amounts that are linked to equity prices or foreign exchange rates.*

***Accounting policies**, paragraph 23 - only significant policies are disclosed and therefore not all entities will necessarily disclose policies for each of items (a) to (f). The introductory phrase should therefore read 'In the case of financial instruments such disclosure may include:'.*

***Fair values**, paragraph 31 - this would be clearer if it were divided into parts dealing with instruments where fair value was determined:*

- *(a) directly from observable market prices*
- *(b) indirectly from observable market prices using valuation techniques*
- *(c) using valuation techniques that are not supported by observable market prices for the instruments in question.*

We also note that transaction prices may be available for financial instruments in which there is no observable market. In such cases transaction prices are arguably more reliable than valuation techniques and should be disclosed accordingly.

***Paragraph 40** – it is unclear what the proposed age analysis in 40 (a) is attempting to capture. The 'analysis' in 40 (b) is undefined – what type of analysis is envisaged? As we have noted above 40 (c) is, in our view, impractical. We are also concerned that the IASB envisages disclosures different from those being proposed by FASB. The effect of presenting two almost identical sets of data might be time-consuming for preparers but it would be confusing for users.*