Fédération Bancaire Européenne

European Banking Federation

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FBE COMMENTS ON EXPOSURE DRAFT 7
FINANCIAL INSTRUMENTS: DISCLOSURES

GENERAL COMMENTS

1. The FBE support the IASB's objective of revising the existing disclosure rules for financial instruments in the light of recent developments in accounting and risk management and of consolidating them together with additional rules on risk disclosures in a single standard.

2. ED 7 is intended to replace, inter alia, the existing IAS 30, which contains disclosure requirements specifically designed for banks and similar financial institutions and thus reflects the special features of the business activities and structures of such undertakings. IAS 30 has exercised a major influence on the standard presentation and classification formats of banks' financial statements. We assume that after IAS 30 has been revoked banks will be permitted to continue using the tried and tested presentation and classification formats in their financial statements.

3. We welcome the fact that the Exposure Draft links the type and extent of the disclosures to the degree to which an entity uses a specific financial instrument and to the level of associated risk. As a result, the proposed disclosure requirements adequately reflect the entity's individual profile.

We also view it as positive that the rules on disclosing risks arising from financial instruments are largely consistent with Basel II's corresponding disclosure requirements for internationally active banks.

4. Some of the required disclosures have a competitive and, therefore, a confidential nature (such as the policies and processes for managing risk and capital, capital targets set by the management, etc). Under Pillar III of the new Basle Accord a bank is entitled to refrain from disclosing information which may seriously endanger its position, provided that it publishes the required information in a more general way and, furthermore, specifies that some information items have not been disclosed and why. It is essential for the forthcoming accounting standard to contain a similar provision.

QUESTION 1- DISCLOSURES RELATING TO THE SIGNIFICANCE OF FINANCIAL INSTRUMENTS TO FINANCIAL POSITION AND PERFORMANCE

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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 BC 13).
(b) information about any allowance account (see paragraphs 17 and BC 14).
(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC 16).
(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 support financial instrument disclosures being located in One Standard.

Given the different measurement bases for the classes of financial instruments defined in IAS 39, we consider it appropriate, in principle, to disclose financial assets and liabilities in the notes on the basis of their classification. The administrative burden involved in classifying and disclosing the carrying amounts of financial assets and liabilities per IAS 39 category as proposed in paragraph 10 would not be unreasonable.

However, we believe that some clarification is needed on the requirement to break down net gains or losses for each category of underlying financial assets and liabilities envisaged in paragraph 21(a). What matters is that readers are informed on whether net gains and losses include interest and dividend income, impairments or fair value attributable to hedged risk. The contents of paragraph 21 (a) should, therefore, be specified more precisely.

We note that some have proposed reinstating the requirement to disclose the effective interest rates for financial liabilities. We believe, however, as the Board did, that the sensitivity analysis which ED7 proposes would provide more useful information. A sensitivity analysis would, moreover be less burdensome. Furthermore, where large financial institutions are concerned, information on the effective interest rates for financial liabilities would be overwhelming or, if aggregated, would not add value. It should also be noted that aggregated information might easily lead users to incorrect conclusions concerning the future debt burden or credit standing of the entity, and cannot be regarded as a substitute for forward looking information or an assessment provided by credit rating experts.

We also note that some also propose reinstating the requirement to disclose the nature of impairment losses. This would, however, seem superfluous insofar as the Exposure Draft would seem to require a detailed account of impairment.

Some would seem to suggest reintroducing IAS 32, paragraph 90, which requires qualitative disclosure on recognition and measurement of equity instruments not measured at fair value. This would, however, not seem necessary as such a requirement would already seem to be covered in paragraph 23 of the Exposure Draft.

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, BC 27 and BC 28).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

We agree that users of financial statements should be provided with information about the type and degree of credit risk, including the probable (net) loss in the event of default. However, we believe this to be better achieved by disclosing the amount of the credit exposure before and after taking account any collateral pledged rather than the fair value of the collateral. It should be reminded in this context that the corresponding Basel II disclosure rules also require disclosure on the basis of gross exposure and net exposure (which does not have to be reported at the level of individual balance sheet positions). In the interests of consistency, and also to avoid confusing users with duplicate disclosure of items that are identical in economic terms, we suggest deleting the requirement in its present form and replacing it with the corresponding Basel II rules.

It must also be added that assessing the fair value of collaterals and other credit enhancements may be unduly burdensome and, furthermore, result in figures which may lack reliability because of their subjectivity.

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 BC 36-BC 39).

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?

Sensitivity analyses of the portfolio of a bank already play an important role in the risk management of many institutions. They provide information about the impact potential changes in a risk variable would have on the fair value of financial instruments and thus on profit and loss and on Equity. We agree, in particular, with the Board that a sensitivity analysis is a simpler and more suitable disclosure than other approaches (see BC36-39), including the tables required by IAS 32, paragraphs 60(a), 67(a) and 67(b).

Nevertheless, we would like to point out that the results of such analyses may include confidential and competitively sensitive information, the disclosure of which would probably prove problematic. Moreover, developing a sensitivity analysis as proposed would require significant work.

With this in mind, we would propose as an alternative to provide entities with the possibility to comply with the proposed requirements by using value-at-risk figures. These are already used for measuring market risk by the majority of internationally active banks and are normally less competitively sensitive than (conventional) sensitivity analyses. Moreover, Basel II also allows value-at-risk figures to be used to comply with its disclosure requirements. We should like to emphasise, however, that value-at-risk figures should be disclosed only as an aggregate exposure (and not on the level of individual balance sheet items), since this is the only way it would be possible to use analyses prepared by the risk management division.

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?

The Exposure Draft requires a large amount of information about an entity's capital to be disclosed, including externally imposed capital requirements, to which banks are particularly subject. While ED 7 does not envisage a quantitative disclosure of capital adequacy requirements, the disclosure of any breaches of capital requirements and the associated regulatory measures subsequently imposed would be particularly sensitive and, if misinterpreted, might have severe consequences and interfere with possible actions taken or being envisaged by competent supervisory authorities. The disclosure of such information should therefore be dispensed with.

There should also be no requirement to disclose quantitative information about management's internal capital targets, since these are merely estimate figures and should not have to be reported externally. Against this background, and in the interests of avoiding misleading conclusions being drawn, we believe the requirement to disclose the over- or undershooting of internal capital targets and any ensuing consequences should also be dropped.

Instead, the Exposure Draft should be aligned with the Basel II disclosure requirements and, therefore, be restricted to the disclosure of the following items:

a) A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.
b) The amount of: Tier 1, Tier 2, Tier 3 and total capital.
c) Deductions from capital.

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?

Provided the Exposure Draft is approved in the course of 2005, we consider mandatory application for periods beginning on or after 1 January 2007 to be appropriate.

We are also in favour of allowing entities to apply the standard before this date.

The envisaged transitional arrangements would exempt entities from providing comparative disclosures only if they adopted IFRSs for the first time and chose to apply this standard before 1 January 2006. However, the retrospective calculation and presentation of comparative information is always problematic, since the required data is either unavailable or disproportionately onerous to compile. This goes not only for first-time adopters of IFRS, but also for entities that already prepare IFRS accounts. We would therefore welcome it if the transitional arrangements were extended to cover also entities already applying IFRS. Moreover, a transitional arrangement valid up to the date of mandatory application would increase the incentive for entities to adopt the standard earlier on a voluntary basis. The proposed transitional arrangement should therefore be extended so that all entities applying the standard voluntarily before 1 January 2007 may dispense with comparative disclosures.

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 believe that it would appropriate to include information on risks from financial instruments in the financial statements as this information is, in fact, drawn from synthetic indicators and is, in other words, not derived immediately from the accounting data. They belong in a Management Discussion and Analysis' document instead.

The major objection against including information on risks arising from financial instruments in the financial statements is that this would imply an audit of the risk management strategy which the entity has adopted. Such an audit would imply an evaluation of the strategic policy of the company – which should not be the task of an auditor

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 do not support amending IFRS 4 Insurance Contracts, as proposed. The contents of IFRS 4 should be discussed first before deciding on issues of disclosure. It should also be reminded in this regard that, in contrast to ED 7, IFRS 4 provides merely provides an option to disclose items. For these reasons the need for the proposed risk disclosures should be reviewed as part of Phase II of the insurance project.

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 helpful if the Implementation Guidance included an example of how to calculate the change in the fair value of a financial liability that is not attributable to changes in a benchmark interest rate (cf. ED 7.12).

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 consider the disclosure requirements which are proposed in ED 7 concerning fair value to be adequate.

QUESTION 10 – OTHER COMMENTS

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

- The disclosure requirements on credit risk which ED 7, Paragraph 40, imposes should apply to the aggregate exposure of financial assets only. A requirement to analyse by class of financial asset past due and impaired assets, in particular, would be unreasonably onerous. Such a requirement would be out of all proportion to the additional information it provided and should therefore be dropped.

- Appendix A of the Exposure Draft defines prepayment risk as "(t)he risk that the counterparty to a financial asset will repay other than when expected". We believe that the definition should be modified as follows: "*The risk that the counterparty to a financial asset will repay other than when expected and on other than market terms*."
