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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting:	**16 September 2008, London**
Project:	**Consolidations**
Subject:	**Credit Crisis Proposed Disclosure Requirements for off-balance sheet entities (Agenda paper 2Ci)**

INTRODUCTION

1 In April 2008 the *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (7 April 2008) was issued to the G7 Ministers and Central Bank governors. It concluded that the period of extreme market turmoil and illiquidity experienced during the credit crisis had highlighted the importance to market confidence of sound, timely disclosure of the risks associated with complex structured credit products and off-balance sheet entities.

2 The Financial Stability Forum (FSF) recommended that the IASB should make it an urgent priority to improve the accounting and disclosure requirements for off-balance sheet entities and the risks attached to involvement in such entities, by moving straight to exposure draft for the new Consolidation standard.

3 This paper outlines the staff's proposals for off-balance sheet entity disclosures being developed for inclusion in the new Consolidation standard that will replace IAS 27

Consolidated and Separate Financial Statements and SIC-12 *Consolidation-Special Purpose Entities.*

4 At the meeting today we will ask Board members to make decisions on whether they agree with the proposed disclosure requirements relating to:

(a) **Consolidation decision made by management**

i Application of consolidation policy

ii Management of reputational risk

iii Financial effect related to the consolidation decision.

(b) **Nature of involvement and risks associated with involvement**

i Disclosure items about the nature of involvement and associated risks

ii Treatment of potential duplication with IFRS 7 (drafting issue).

5 In developing these disclosure requirements, we looked at existing IFRS requirements in relation to the risks associated with off-balance sheet entities, mainly contained in IFRS 7 *Financial Instruments: Disclosures* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* A summary of the key requirements in these standards is included in Appendix 3 to agenda paper 2Cii.

6 Our assessment of what qualitative and quantitative information may be helpful to users is based largely on discussions we held with preparers, users and auditors of financial statements and research we carried out on 'good / best practise' included in observations made by various bodies including KPMG, PwC, the Senior Supervisors Group (SSG) and the Committee of European Banking Supervisors (CEBS). We look at this more closely in the next section and a detailed analysis is included in Appendix 1 to agenda paper 2Cii.

7 The disclosure proposals in this paper are applicable for all market conditions, not just the distressed ones witnessed during the credit crisis and all sectors, not just the financial services sector. In relation to the disclosure threshold, we will present a separate paper, at a future date, on the concept of significant involvement.

8 This paper sets out:

(a) background information on the credit crisis

(b) an analysis of disclosures made in 2007 annual reports and good practise

(c) Consolidation standard-staff disclosure proposals

(d) Conclusion

(e) questions for the Board.

BACKGROUND

9 Structured vehicle activities and related products have been affected by significant losses and lack of liquidity over the past 12 months. As a result of the credit crisis this area has become a source of considerable debate and concern in the investor and regulatory communities. There has been considerable external pressure, from audit firms, investors and regulators, to improve transparency so that disclosures provide a more comprehensive picture of the scope and magnitude of exposures to off-balance sheet arrangements.

10 In developing disclosure requirements for off-balance-sheet entities, we looked at the impact of the credit crisis and carried out an analysis of disclosures in the 2007 annual reports of institutions in the financial services sector. Commentators widely observed there had been an improvement in disclosure over previous reporting periods, possibly as a result of the credit crisis or the implementation of IFRS 7, which became effective 1st January 2007, or both.

11 Despite this overall improvement, PwC concluded in their report entitled *Accounting for change: transparency in the midst of turmoil. A survey of banks' 2007 annual reports* (August 2008) that users of financial statements may still find it difficult to assess fully the exposure and nature of risks attached to complex structured finance activities. In its report PwC concluded:

> 'Given the unprecedented growth in structured finance activities, the risks they represent and the effects of recent market events, structured finance disclosures require a fresh look.'

<u>Impact of the Credit Crisis</u>

12 The long period of benign economic conditions preceding the credit crisis, that witnessed abundant financial market liquidity and generally low credit spreads, had stimulated an expanding market for the securitisation of credit risk and the development of the 'originate to distribute' model[1], which enabled banks to diversify risk and provided them with leverage and capital to undertake more business.

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[1] In the IMF's report on Structured Finance: Issues of Valuation & Disclosure the issuance of selected structured credit products in US and Europe grew from $500 billion in 2000 to $2.6 trillion in 2007. Global issuance of CDOs grew from $150 billion in 2000 to $1.2 trillion in 2007.

13 During this period many banks and financial institutions established off-balance sheet funding and investment vehicles, which in many cases invested in highly rated structured credit products, largely backed by mortgage-backed securities.

14 The rising delinquencies in US sub-prime residential mortgages and the resultant decline in asset values led to multibillion dollar writes downs of complex structured products often housed in these off-balance sheet vehicles. Due to lack of investor appetite for many types of credit instruments, such as mortgage-backed securities (MBSs), other asset-backed securities (ABSs) and collateralised debt obligations (CDOs), the market for these products became illiquid.

15 As investor interest in such investments fell sharply, institutions' willingness to extend credit and liquidity to others tightened, because they wanted to retain liquidity for themselves and because they had grown uncertain about counterparty exposure to losses.

16 As a consequence, sponsoring banks struggled to roll over or refinance maturing debt through asset sales or the issue of new commercial paper. The decline in asset values and liquidity problems caused by the tightening of short term money markets led to a number of off-balance sheet conduits and structured investment vehicles either falling into administration or requiring rescue packages from the banks that had set them up and sponsored them.

17 Faced with this situation, some banks provided non-contractual liquidity support, that caused them to bring some vehicles back onto their balance sheets to protect against potential damage to their business reputations and their ability to sell investments in such vehicles in the future if they failed to provide support during this period of market distress.

18 The Senior Supervisors Group (SSG) in its report, *Observations on Risk Management Practices during the Recent Market Turbulence* (March 2008), commented that during the credit crisis:

> 'Several firms did not properly recognise or control for the contingent liquidity risk in their conduit businesses or recognise the reputational risks associated with the SIV business.'

19 As a result of the credit crisis, regulators and investors have questioned the adequacy of disclosures made by financial institutions and stated that lack of transparency has undermined market confidence. Financial statements are the primary source of information about a company's financial position, performance, and profitability. Investors require such information to enable them to assess the timing and certainty of cash flows when investing in a particular company.

20 The FSF's report on enhancing market and institutional resilience stated that weaknesses in public disclosures, required of financial institutions, did not always make clear the type and magnitude of risks associated with on and off-balance sheet exposures. It continues by observing that where information was disclosed, it was often not done in a way that was easily accessible or usable. In its view, sound disclosure practises are essential to achieve transparency and to maintain market confidence and promote market discipline.

Analysis of disclosures made in 2007 annual reports and 'good practise'

21 The credit crisis has prompted a significant amount of debate and led to the recent publication of many reports that look at the adequacy of disclosures in the 2007 annual reports of institutions in the financial services sector.

22 Prior to the implementation of IFRS 7 there were limited specific disclosure requirements for non-consolidated entities. As a consequence, most disclosures that were made were largely voluntary. However it has been observed that, in comparison to 2006, some banks have significantly increased the extent of disclosure relating to their involvement in off-balance sheet vehicles. This may be in direct response to the sub-prime crisis or the implementation of IFRS 7, which became effective 1 January 2007, or a combination of both.

23 In its report *Accounting for change: transparency in the midst of turmoil. A survey of banks' 2007 annual reports* (August 2008), PwC noted that there had been an overall improvement in structured finance-related disclosures in the 2007 annual reports of 22 banks surveyed, due to new disclosures focusing on activities most impacted by market events. They went on to state that the quality and content of disclosures was, however, variable among the surveyed banks. Overall, disclosures around the type,

extent and complexity of structured finance activities remained diverse in quality and readability.

24 PwC concluded that because the information was provided in different parts of the financial statements and Management Discussion and Analysis (MD&A), and was often subsumed within other general disclosures (such as those required by IFRS 7), this rendered it difficult to access relevant information and hindered comparability.

25 In its report *Focus on transparency. Trends in the presentation of financial statements and disclosure of information by European banks.* (June 2008), KPMG noted that more than 50% of the banks surveyed (including 17 of the largest European banks that report under IFRS) presented detailed quantitative and qualitative disclosures in respect of :

(a) the volume of assets held by non-consolidated vehicles

(b) liquidity or other facilities provided to the vehicles

(c) investments in notes issued by the vehicles

(d) information in conjunction with the relationship between the banks and vehicles.

This suggests that many other financial institutions are not currently providing the sort of information that may be beneficial to users.

26 The fact that these observations were made in connection with IFRS 7-compliant financial statements is interesting in that there is evidently a perceived need to ensure that institutions disclose involvement in off-balance sheet entities adequately and provide better information about the risks attached to this involvement.

27 The Committee of European Banking Supervisors (CEBS) issued a report in June 2008 entitled *CEBS report on banks' transparency on activities and products affected by the recent market turmoil.* In this report the CEBS recommends that institutions adopt a 'holistic' approach to disclosure and promotes the idea that disclosures should 'tell a coherent story', in order to assist the reader in understanding the background to an involvement, its impact and importance. Information relating to how involvement in off-balance sheet entities fits in with the reporting entity's business strategy was also considered to be important.

28 The CEBS, based on its observations, recognised a need to enhance disclosures relating to those risks incurred through involvement with activities affected by the recent market turmoil, including information relating to an entity's maximum exposure to loss and how this is calculated, and how these risks are managed.

29 In order to improve the way disclosures are presented, the CEBS recommended that all disclosures, for both consolidated and non-consolidated entities, are located in one place in the financial statements and that illustrative tables, containing key quantitative information, are used, together with supporting narrative, to make disclosures more 'user-friendly' and accessible.

30 The SSG's report on *Leading Practice Disclosures for Selected Exposures* (April 2008) was issued in response to the FSF's request that the SSG undertake a review of disclosure practises regarding exposures to instruments that the market place now considers 'high risk', or to involve more risk than previously thought, including CDOs, residential mortgage backed securities (RMBSs), commercial mortgage backed securities (CMBSs), and other SPEs. The sample used by the SSG was drawn from 20 large international financial firms, comprising 15 banks and 5 securities firms. [2]

31 In its report, the SSG highlighted the following disclosures as 'best practise' in relation to SPEs:

(a) size of SPE versus firm's total exposure

(b) activities of SPE

(c) reason for consolidation (if applicable)

(d) nature of the exposure (sponsor, liquidity and/or credit enhancement provider)

(e) collateral type

(f) geographic distribution of collateral

(g) average maturity of collateral

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[2] Banks and securities firms surveyed: Bank of America Corporation, The Bank of New York Mellon Corporation, Barclays, Bear Stearns Companies, BNP Paribas Group, Citigroup, Commerzbank, Credit Suisse Group, Deutsche Bank, Goldman Sachs Group, HSBC Holdings, JP Morgan Chase & Co.,Lehman Brothers Holdings, Merrill Lynch & Co., Morgan Stanley, The Royal Bank of Scotland Group, Societe Generale Group, State Street Corporation, UBS, Wachovia Corporation.

(h) credit ratings of underlying collateral.

32 In the *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,* the FSF recommended strongly that financial institutions use the leading disclosure practises, recommended by the SSG, at the time of their upcoming mid-year 2008 reports. We are currently conducting a review of these disclosures.

33 In the introduction to its report, the SSG states that:

> 'The results of the survey indicate that disclosure *practices* can be enhanced without necessarily amending existing disclosure *requirements*, as disclosure requirements allow firms considerable discretion in how they convey information.'

34 Whilst we agree that disclosures should be principles-based and 'through the eyes of management', we have questioned whether more guidance should be provided relating to the types of information users may find helpful.

35 In summary, whilst the credit crisis and the implementation of IFRS 7 have resulted in an improvement in disclosures, the level and quality of disclosure in 2007 annual reports, according to commentators, was inconsistent across financial institutions and, in many cases, failed to provide an adequate level of transparency to investors and regulators. Appendix 1 to agenda paper 2Cii provides more detailed information on observations made.

CONSOLIDATION STANDARD –STAFF DISCLOSURE PROPOSALS

Principles-based disclosure framework

36 Disclosure requirements in IFRSs provide flexibility in terms of how information is organised and presented depending on management's assessment of the facts and circumstances. They are largely based on information provided internally to key management personnel, which is consistent with disclosures being made 'through the eyes of management'. This avoids a 'checklist' approach and resultant 'boilerplate' disclosures.

37 Application of IFRS, should result in disclosures that reflect the specific requirements of the reporting entity, providing users with more pertinent information that better reflects the economics of the relationship and associated exposure to risk. In essence, the ultimate disclosure requirements in the Consolidation standard will retain the principles-based feature of being 'through the eyes of management.'

38 The proposals in paragraph 97 below are not intended to be prescriptive, they represent indicators of the sort of items that management should consider when providing information about its exposure to off-balance sheet entities.

39 Consistent with a principles-based disclosure framework, we think that an entity should be required to disclose information to the extent that it is necessary for an understanding of the effect that its involvement in off-balance sheet entities has, or may have, on its financial condition, profit or loss, liquidity and capital resources.

40 The proposals in this paper do not focus on the wording of the disclosure requirements as they would ultimately appear in the standard; rather our focus has been on assessing what sort of information, we believe, would be helpful to users of financial statements and should be considered by management for disclosure purposes. Such information will, most likely, be included in the Application Guidance section of the standard.

Proposals

41 Reporting entities sometimes use separate legal structures to assist them in managing their financing, investing or servicing activities. The activities and the structures, in which they are housed, are given numerous labels such as special purpose entities (SPEs) or structured investment vehicles (SIVs), and conduits.

42 Assessing whether such structured vehicles should be consolidated is beyond the scope of this paper. The disclosure proposals in this paper relate to those entities that have not been consolidated but where the reporting entity has significant involvement.

43 The development of a new Consolidation standard has presented us with an opportunity to re-visit existing disclosure requirements in IFRSs for off-balance sheet entities and to assess how they could be enhanced. The disclosure requirements we propose for inclusion in the Consolidation standard, in relation to non-consolidated entities, cover the following main areas:

(a) **Consolidation decision made by management**

- i Application of consolidation policy
- ii Management of reputational risk
- iii Financial effect related to consolidation decision

(b) **Nature of involvement and risks associated with involvement**

- i Disclosure items about the nature of involvement and associated risks

(c) **Other considerations**

- i Presentation of information

Consolidation decision made by management

Application of consolidation policy

<u>The issue</u>

44 In accordance with paragraph 122 of IAS 1 *Presentation of Financial Statements*, entities are required to disclose those judgements used when applying their accounting policies and those policies that have the most significant effect on amounts recognised in the financial statements.

45 PwC, KPMG and CEBS noted, in their respective reports, that, in practise, information around the decision to consolidate (or not) in 2007 disclosures was largely inadequate. For many of the banks surveyed, they found that the significant accounting policy disclosures surrounding SPEs failed to provide a tailored discussion of the specific policies. Quite often they took the form of a repetition of the wording in the consolidation standards.

<u>Staff analysis</u>

46 We think users should have access to information that enables them to evaluate the judgements and subjective assumptions that management has made when reaching a decision to consolidate or not, where the application of judgement has been significant.

47 We think that in these circumstances there is value in providing users with information about the deliberation processes that management went through and the assumptions it applied in the power and benefits tests surrounding the consolidation assessment.

48 Where an entity has reversed a consolidation decision, we think, the disclosure requirement should be restricted to those circumstances where it is as a result of a fundamental change in judgement, rather than for those cases where there is a clear business reason for loss of control. Although, we do not expect this to be a frequent occurrence, it is beneficial for users to know why management has reversed a decision when there is no evident reason for that change and significant judgement has been applied.

49 This disclosure requirement would apply equally to those circumstances where a previously off-balance sheet entity is consolidated. The occurrence during the credit crisis where off-balance sheet vehicles were brought back on balance sheet by some financial institutions, in order to mitigate reputational risk, highlights the need to provide users with detailed and tailored guidance about judgements made, from which they can assess the likelihood of future exposure to risk.

50 We think it is important to recognise whether the reporting entity has any discretion or ability to avoid being given control of the entity. We also recognise the need to distinguish between:

(a) a fundamental change in judgement and

(b) where the reporting entity 'did something', such as the provision of liquidity support, to change circumstances, which may have led, correctly, to a re-assessment of the control decision and consolidation.

Staff proposal

51 We propose that the reporting entity be required to describe the basis for its decision to consolidate (or not) an entity, in which it has significant involvement, where management has had to exercise significant judgement or where a presumption for consolidation was rebutted.

52 Moreover, we think, more detailed disclosure should be provided when the consolidation decision is an especially difficult one and the assessment of control is not straight forward.

53 If an entity was consolidated in a previous year, but is not now, and where there has been no evident reason for loss of control, management should explain why and how it has assessed that it no longer controls the entity in those instances where significant judgement has been applied.

54 We propose that disclosures relating to the potential for future consolidation where, for example, this may be due to the ability to exercise put options that currently exist, but are not currently exercisable, would be beneficial. This will enable users to assess the risk that an off-balance sheet entity may be required to be consolidated at a future point.

Management of reputational risk

The issue

55 As a result of the credit crisis, some banks, concerned about the risk to their reputations and security of future revenue streams, decided, or were compelled, to rescue off-balance sheet vehicles they had sponsored by providing liquidity support and bringing them back onto their balance sheets.

56 Commentators observed that banks did not disclose adequately their non-contractual off-balance sheet exposures to entities, such as conduits and SIVs. In its survey PwC observed that 4 banks disclosed voluntary (non-contractual) support.

57 Commentators also questioned whether entities are explaining their approach to the management of reputational risk adequately. They think that where the entity did not initially meet the requirements for consolidation, there should be adequate disclosure about the potential risks that arise from this involvement.

58 The decision to consolidate previously off-balance sheet entities to mitigate reputational risk resulted in additional costs for some banks and also led to an expansion in their liquidity and capital needs. This action may also have exposed them to further losses. Such information is of evident interest to investors, since they may be exposed to additional risk as a result of the vehicles being consolidated.

Staff analysis

59 One major bank, in its 2007 financial statements, disclosed the circumstances related to its provision of non-contractual support and the financial effect of the decision to consolidate.

60 Further, in its disclosure of contingent liquidity risk it stated that it recognises that, in times of market stress, there may be situations where it may choose to provide non-contractual liquidity support for products and vehicles, with which it is associated. It stated that such potential support would not be included in the Group’s liquidity risk measures *until such time as the support becomes legally binding.*

61 In general, we think that disclosure requirements requesting information relating to the potential provision of non-contractual support are not beneficial, since they are *predictive* in nature. In the majority of cases, a reporting entity will not know in advance when it will provide non-contractual liquidity support to mitigate reputational risk until the urgency of the situation requires it.

62 However, the staff consider that it is beneficial to require explanation of the reporting entity's approach to managing reputational risk where it has arisen, or where there is a strong likelihood that it will arise, and steps have been taken to protect against it. Consequently, we believe that it is important that disclosure is made when a reporting entity has taken action and provided non-contractual support in the reporting period.

63 The fact that a reporting entity has provided this sort of support in the reporting period may be of benefit to users and might signal how it would deal with a similar future event, or at least provide a the basis for further probing by users.

Staff proposal

64 The staff propose that an entity be required to disclose how it manages reputational risk, as well as disclosure of those instances for which the entity has provided non-contractual support to mitigate it. Such disclosure should explain the nature and circumstances of the voluntary support provided and the financial effect if that support causes the vehicle to be consolidated.

Financial effect related to the consolidation decision

The issue

65 In their report PwC noted that, whilst many surveyed banks provided details of maximum exposure to credit risk, the majority did not provide comprehensive disclosures on the potential financial effect should the bank be required to consolidate an off-balance sheet entity, or incur significant losses as a result of consolidation.

Staff analysis

66 This disclosure would enable users to assess the financial reporting effect of the consolidation decision on the reporting entity's financial statements where reversal of the decision is due to a fundamental change in judgement.

Staff proposal

67	Where an off-balance sheet entity is consolidated, and this has arisen as a result of a fundamental change in judgement (as opposed to a change in circumstances), we propose that the reporting entity be required to disclose the effect on key financial indicators, including, but not limited to, capital ratios, credit ratings, dividends and exposure to losses.

Nature of involvement and risks associated with involvement

Disclosure items about the nature of involvement and associated risks[3]

<u>The issue</u>

Telling a 'coherent story'

68 Disclosures made in 2007 annual reports, according to the CEBS, failed to provide a 'coherent story' which would assist users in understanding the background to an involvement, its impact and importance.

69 There is increasing external pressure for disclosures to provide narrative information relating to how a company is performing and how its business strategy creates value. Many commentators, including the SSG, the CEBS and PwC, have recommended that more qualitative information should be disclosed relating to activities carried out by off-balance sheet entities and how they fit into the reporting entity's business model.

70 The results of a survey carried out in 2007 into the financial reporting supply chain, commissioned by the International Federation of Accountants (IFAC), revealed that users and preparers of accounts are keen for more information, that is actually used to run businesses, to be included in the audited sections of published financial reports.

71 One of the big criticisms of current disclosure practise, referred to in the IFAC survey, is that a 'check-box mentality' has emerged among report preparers. Far from explaining the business to the wider market, this approach has encouraged companies to issue 'boilerplate' statements around governance and to avoid any discussion of business metrics, including the strategic information and narrative reporting that the market demands.

<u>Staff analysis</u>

72 An entity becomes involved in another entity in anticipation of receiving a return. Involvement may take various forms, including investing in equity, sponsoring, providing financial support or managing services. There is a correlation between risk and return. Accordingly, we think that disclosing risk information only is

[3] FIN 46 (R) currently requires disclosure of the nature of involvement in significant Variable Interest Entities (VIEs) as well as disclosure of purpose, size and activities of VIEs.

inappropriate, since it fails to portray the essence of the involvement. We think disclosures should provide a cohesive overview, incorporating the 'upside' of an involvement, as well as the 'downside'.

73 The staff disclosure proposals relating to the nature and level of involvement in off-balance sheet entities would ensure that quantitative and qualitative disclosures are captured for *all* relationships, where the involvement is significant, irrespective of whether this involves a financial instrument or not.

74 We think that more qualitative information would be of benefit to users, since it provides them with the business reasons behind the involvement in off-balance sheet entities and how this fits into the business strategy and how they contribute to shareholder wealth. Structured finance vehicles are often complex in nature and information about what they do may help de-mystify commonly used descriptions and definitions, which may not be comprehensible to the average investor.

75 Disclosures should be aggregated in a way that reflects how management views its involvement in off-balance sheet entities and the risks attached to these exposures. However, disclosures provided at a level which is too aggregated may obscure useful information. Equally, meaningful information and clarity may be concealed by disclosures that are too detailed and superfluous.

76 In general, the level of detail provided in disclosures may fluctuate according to, for example, the risk profile relating to different financial products or vehicles. Additionally, granularity may vary from period to period to reflect changes in different market conditions. For example, in the current credit crisis we have seen more disclosure relating to residential and commercial real estate and leveraged loan exposures.

77 The challenge for management is to decide, based on its circumstances, how much detail should be provided and how much emphasis it should place on different aspects, in order to provide users with clear, meaningful and relevant information.

The issue

The need for enhanced risk disclosures

78 In practise, the disclosures in 2007 annual reports were perceived by many commentators as failing to provide the required transparency in relation to the risks associated with off-balance sheet structured finance vehicles, in which financial instruments reside. Commentators noted that quantitative disclosure by category of risk (market, credit, and liquidity) was often not provided in an aggregated and meaningful way for such entities.

79 According to the CEBS only a few banks were observed as providing adequate disclosure around any credit enhancements or liquidity support provided.

80 In its survey, PwC noted that 6 banks included off balance sheet items, such as loans and other commitments, in the maturity analysis for liquidity risk, whilst 8 banks failed to disclose off-balance sheet items in the liquidity table. KPMG noted that 7 banks, in its survey, included off-balance sheet items, such as loan commitments, in the liquidity risk analysis template.

81 In restricting their disclosures relating to ‘off-balance’ sheet entities during the recent market turmoil, commentators observed that sponsoring banks made judgements that their obligations were contingencies unlikely to be drawn upon.

82 Several commentators noted that there was a lack of disclosure on the reporting entity’s maximum exposure to loss, arising from its involvement with non-consolidated entities, and how that exposure was calculated, along with a description of any actions taken to minimise that exposure to loss, such as hedging and collateral.

Staff analysis

83 Considering that 2007 was the first year of adoption of IFRS 7 and that many organisations encountered implementation issues, it may be premature to assess its effectiveness based purely on 2007 financial reports, especially in light of the fact that this coincided with a period of extreme market turmoil.

84 However, observations made on 2007 disclosures imply that the quality and quantity of risk disclosures for off-balance sheet entities was variable, due to the widespread diversity in how risk requirements were interpreted and applied. Frequently disclosures failed to provide the required transparency in relation to the risks associated with these structured finance vehicles.

85 It was observed that in practise many financial institutions failed to provide adequate information relating to the provision of credit enhancement and liquidity support.

86 The provision of credit enhancement, a common feature of structured finance activities, for example, often exposes the provider to risks and losses greater than what is recognised in the financial statements. Credit enhancement techniques have frequently been applied to obtain a high rating from a credit rating agency, in order to attract investment. Such techniques may include the issuance of credit insurance, third party guarantees providing collateral, including 'over-collateralization' (which equates to financing a pool of assets by a smaller amount of external debt) and note subordination.

87 Banks are often linked to structured investment vehicles via future funding commitments (liquidity facilities), which may require the bank to provide financial support at some time in the future. The liquidity support provided may be in the form of cash, a guarantee to invest in an entity, such as the purchase of commercial paper that cannot be rolled over or a commitment to purchase assets. This sort of information is of evident interest to the investor community.

88 Disclosure of contingent liabilities was also, according to commentators, inadequate. It would be beneficial if investors had access to information about the nature of contingent liabilities and were able to assess the risks that such obligations may entail.

89 We believe that the shortcomings in 2007 disclosures may be attributed more to disclosure practise than a deficiency in disclosures requirements, since being through 'the eyes of management', entities are provided with flexibility in determining the content and extent of disclosures, by focusing on this issues that are relevant to their circumstances. The staff think that there is a case for providing additional disclosure guidance to improve quality and consistency of disclosures.

The issue

Inaccessibility of disclosures

90 Some commentators, including the CEBS and PWC, expressed concerns that a lack of clarity and transparency arises from disclosures relating to structured finance activity being included in the general disclosure of ‘other vanilla products,’ which may overlook the inherent risks of the overall structure.

91 Having to extract information specific to structured vehicles is problematic since, quite often, the information is included in numerous other disclosures, appearing in several locations throughout the MD&A and notes to the financial statements.

92 PwC noted that the fact that disclosures are not found or referenced in a single location inhibited a detailed comparison and analysis. One financial institution overcame this problem in its annual report by providing a table, which summarised where disclosures relating to off-balance sheet arrangements could be found in the notes to the financial statements. [Table has been omitted from the Observer Notes.]

Staff analysis

93 Both PwC and the CEBS remarked that it is difficult for users to assess the overall exposure to risk relating to off-balance sheet entities, since the disclosure requirements appear in different standards and are presented in different notes in the financial statements. The staff proposal would help overcome this issue.

94 Some commentators have noted that a ‘shadow’ or ‘parallel’ balance sheet’ disclosure, is useful, since it provides a summary of the reporting entity’s gross exposure to the underlying assets and liabilities of the off-balance sheet entities, with which it has significant involvement. The assets and liabilities could be presented so that a user can identify the scale of the assets and liabilities of off-balance sheet entities with similar economic characteristics, relative to the assets and liabilities of entities that the reporting entity controls. Such a disclosure is not intended to extrapolate what the entity’s balance sheet would look like if those other entities were consolidated, rather it provides a high-level overview of the reporting entity’s

involvement in consolidated and non-consolidated entities. Management should consider the use of such tables, where it believes there is benefit in doing so.

95 We think that there is value in bringing disclosures relating to involvement in off-balance sheet entities together so that the user is provided with an overview of the reporting entity's exposure to this potentially 'risky' subset of structured finance activity. Additionally, it would also provide users with a summarised overview of the nature and business reasons for the involvement, including disclosure of associated benefits as well as risks.

Staff proposal relating to the nature of involvement and associated risks

96	We propose that management be required to provide a summarised overview of its involvement in off-balance sheet entities, including both qualitative and quantitative information relating to the nature of its involvement and associated risks and benefits. This information should be aggregated so that entities with similar economic characteristics are aggregated into a single category. The categories are to be determined by management, based on the reporting entity's business structure and segmentation.

97 The following sort of information, we believe, would enable users to make more-informed investment decisions:

(a) **The nature and extent of the involvement**

This might include, for example, whether the reporting entity has a retained or purchased interest in the entity. Disclosure of whether the reporting entity has some other involvement, such as being a sponsor and / or provider of liquidity support and / or credit enhancement.

(b) **How the involvement fits into the reporting entity's business model**

Structured finance vehicles are often set up to meet a variety of specific business needs, such as to facilitate the securitisation of financial assets, for internal risk management purposes, for tax reasons, to obtain liquidity, to achieve favourable capital treatment or to offer investment opportunities to customers. Disclosure of business model operated, such as 'originate-to-distribute', 'buy-to-hold' or mixed model.

(c) **Forms of funding**

Disclosure of the different types of involvement including, for example, whether this is achieved through the issue of commercial paper or medium term notes.

(d) **The reporting entity's exposure**

The reporting entity's exposure in comparison to the size of the structured finance vehicle and the related fees and expenses the activity generates. This summarised information might include disclosure of:

i for each category of entity, concentrations of assets or liability maturities, that help users assess the risks to which entity is exposed. This may include the weighted life and credit rating of the off-balance sheet entity's assets and other information relating to types of collateral, including industry and geographic distribution.

ii the benefits, as well as the risks, created by the involvement. Such information may include fees generated by acting as administrator or provider of liquidity or credit enhancement

iii cash flow information including assumptions relating to the prepayment rate, expected credit losses and discount rate

iv details of credit enhancements and liquidity support provided, including information relating to terms and conditions and whether there are any third party providers and how they rank

v exposure to delinquencies, credit losses and material write down of assets

vi exposure to 'first loss'

vii disclosure of maximum exposure to loss and how this is calculated

viii supporting commentary on how the institution's situation could be effected by further downturn or market recovery

ix the effect of further downturns on exposures through the calculation of maximum exposure to loss

x disclosure of other potential risk concentrations

98 The above list is not exhaustive, nor will all items be applicable to all reporting entities. It represents the sort of quantitative and qualitative disclosures management might consider in providing information about its exposure to off-balance sheet entities.

99 In the next section we shall look at how the proposed risk disclosures for inclusion in the Consolidation standard compare to existing requirements in IFRS 7. There is a

drafting question for Board members relating to how the potential duplication with the disclosure requirements in IFRS 7 should be dealt with.

Comparison of risk disclosure requirements with IFRS 7

100 This section relates to the risks included in the disclosure proposals for the reporting entity's exposure in paragraph 97 (d) above. In including this risk information, we were conscious of the need to both :

(a) close a potential disclosure gap

(b) deal with a potential duplication of the disclosure requirements in IFRS 7.

<u>Closing the disclosure gap</u>

The issue

101 The disclosure framework in IFRS 7 has minimum requirements, but also provides sufficient flexibility to allow an entity to tailor disclosures to their own risk profile and management strategies. It contains robust disclosure requirements in relation to potential risks relating to on and off balance sheet exposures, as well as information relating to management's objectives, policies and processes for measuring, monitoring and controlling risk, including concentrations with respect to:

(a) liquidity and capital resources

(b) market risk

(c) credit risk.

102 A reporting entity may be exposed to any of the above risks through its involvement with an off-balance sheet entity. For example, where the reporting entity has set up an entity and has retained or purchased an interest in the entity, it is required to disclose its exposure to risk and how it manages this risk in accordance with IFRS 7, since its interest represents a financial instrument.

103 Additionally, if acting in a sponsorship capacity solely, the reporting entity would be required to disclose any information relating to its involvement, in accordance with existing IFRS requirements in IFRS 7 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, where any contractual or contingent obligations exist.

104 On the other hand, when the reporting entity acts as a sponsor, but does not hold any interests or commitments, IFRS 7 does not require any disclosure and there is a potential disclosure gap.

Staff comment

105 The proposals we recommend relating to the disclosure of the nature and level of involvement in off-balance sheet entities (paragraph 97 above) would ensure that qualitative and quantitative disclosures are captured for **all relationships**, where the involvement is significant, irrespective of whether this involves a financial instrument or not.

106 Although we accept that exposure to risk, if acting solely in a sponsorship capacity, may be limited, the staff proposal would close any potential disclosure gap. If acting as a sponsor only, the reporting entity may, of course, be exposed to the risk of consolidating the entity, which we cover under the proposals relating to the Application of consolidation policy.

<u>Duplication of risk disclosure requirements with IFRS 7 (drafting issue)</u>

The issue

107 As stated above, where the reporting entity has set up an off-balance sheet legal entity and has retained or purchased an ownership interest in this entity, it is required to disclose information in accordance with IFRS 7, since its interest represents a financial instrument.

108 In the disclosure proposals relating to the reporting entity's exposure to off-balance sheet entities (paragraph 97 (d)) we recommend that risk information is provided, together with comprehensive information relating to the involvement and associated benefits, to provide users with an overview of the reporting entity's exposure. This represents a potential overlap with the requirements in IFRS 7 where the reporting entity holds a financial instrument in the underlying entity.

Staff comment

109 We think that risk information is an integral part of the disclosures relating to the reporting entity's exposure to off-balance sheet entities. As proposed in the previous section there is value in providing users with a comprehensive overview of its exposure to off-balance sheet entities, including information relating to both the benefits and the risks associated with the involvement.

Staff proposals

110 Since the inclusion of risk information in our proposals represent a potential duplication with the disclosure requirements in IFRS 7, we seek Board input on whether:

(a) IFRS 7 should be amended to capture risk disclosure for off-balance sheet structured finance vehicles or

(b) the disclosure requirements should be included as part of the Consolidation standard.

111 We came up with the following two drafting options:

Option 1

112 Amend the wording of the disclosure requirements in IFRS 7 to ensure that risk disclosures by category of risk (market, credit, and liquidity) are provided in an aggregated and meaningful way for financial instruments housed in structured finance vehicles. Consider the inclusion of Application Guidance to provide indicators of the sort of disclosures management might consider.

113 Retain the qualitative information about the nature and level of involvement as disclosure requirements in the Consolidation standard, along with information about benefits of the association. Include risk information relating to the nature and level of the reporting entity's exposure, cross referenced to the disclosure requirements in IFRS 7 and where appropriate to IAS 37 for disclosure of contingent obligations.

Option 2

114 Include risk disclosure requirements in relation to the nature and level of involvement in the Consolidation standard.

Staff recommendation

115 We recommend option 1 above for the following reasons:

(a) it retains all risk disclosures in one dedicated standard, IFRS 7

(b) it ensures that an overview of the reporting entity's exposure to off-balance sheet entities, including risk disclosures required by IFRS 7, are brought together in applying the Consolidation standard.

Other considerations

Presentation of information

The issue

116 A number of bodies, including the CEBS and PwC in their respective reports, favoured the use of illustrative tables in disclosures. [These have been omitted from the Observer Notes.]

Staff comment

117 We think that management may be able to better articulate its story through the use of information in tabular format, where, for example, it wants to convey a lot of quantitative information. Whilst a tabular format may be an effective and highly visible way of summarising and presenting data, we are not proposing that it should be made a mandatory disclosure requirement in the Consolidation standard. Management should decide whether of its use is beneficial to users. Management should also determine the most appropriate content and categorisation for such tables, based on its business circumstances.

CONCLUSION

118 Commentators observed an overall improvement in disclosure in the 2007 annual reports of financial institutions, perhaps as a direct result of the credit crisis as voluntary disclosures were provided in response to the demands of the capital markets. It may also be attributed to the implementation of IFRS 7, or perhaps a combination of both.

119 Much of what commentators observed was, however, very variable, both in terms of the quality and quantity of disclosures, and this hindered comparability across the financial sector. The quantitative disclosures by category of risk (market, credit, and liquidity) in 2007 annual reports were also perceived, by many commentators, as failing to provide information in an aggregated and meaningful way for off-balance sheet entities.

120 Whilst the credit crisis has highlighted the need for more transparency and enhanced disclosures, especially in relation to the ‘high risk’ subset of off-balance sheet structured finance vehicles, we do not think that existing IFRS disclosure requirements, or the principles underpinning them, are fundamentally flawed.

121 Being principles-based, the disclosure framework under IFRS provides management with flexibility to focus on the areas that they think are most relevant to their business and the needs of the users of their financial statements. However, we propose that additional guidance may be required to improve quality and consistency and provide indicators of the type of disclosure that might better serve the needs of users.

122 The disclosure proposals we are recommending, as part of the future Consolidation standard, provide users with qualitative and quantitative information about the nature and extent of involvement in off-balance sheet entities and the risks attached to such involvements. Disclosure around the consolidation decision, where significant judgment is applied, and the financial effect of consolidating such entities will also provide meaningful information to users. Based on Board feedback we shall incorporate these proposals into a revised exposure draft to be issued in the fourth quarter of 2008.

Questions for the Board

Application of consolidation policy *(Paragraph 51)*

Q1 We propose that the reporting entity be required to describe the basis for its decision to consolidate (or not) an entity, in which it has significant involvement, where management has had to exercise significant judgement or where a presumption for consolidation was rebutted. Do you agree?

Management of reputational risk *(Paragraph 64)*

Q2 The staff propose that an entity be required to disclose how it manages reputational risk, as well as disclosure of those instances for which the entity has provided non-contractual support to mitigate it. Such disclosure should explain the nature and circumstances of the voluntary support provided and the financial effect if that support causes the vehicle to be consolidated. Do you agree?

Financial effect related to the consolidation decision *(Paragraph 67)*

Q3 Where an off-balance sheet entity is consolidated, and this has arisen as a result of a fundamental change in judgement (as opposed to a change in circumstances), we propose that the reporting entity be required to disclose the effect on key financial indicators, including, but not limited to, capital ratios, credit ratings, dividends and exposure to losses. Do you agree?

Disclosure items about the nature of involvement and associated risks *(Paragraph 96)*

Q4 We propose that management be required to provide a summarised overview of its involvement in off-balance sheet entities, including both qualitative and quantitative information relating to the nature of its involvement and associated risks and benefits. This information should be aggregated so that entities with similar economic characteristics are aggregated into a single category. The categories are to be determined by management, based on the reporting entity's business structure and segmentation. Do you agree?

<u>Questions for the Board (continued)</u>

Duplication with IFRS 7-drafting issue *(Paragraphs 112-115)*

Q5 We propose that risk information is included in disclosures relating to the reporting entity's exposure to off-balance sheet entities, since this provides users with a cohesive overview of the involvement and the associated risks. In practise, 2007 IFRS 7-compliant disclosures, according to commentators, failed to provide the required transparency in relation to the magnitude of the risks associated with the structured vehicles, in which financial instruments reside.

In order to deal with any potential duplication with the disclosure requirements in IFRS 7, the staff proposed 2 drafting options:

Option 1-Amend the wording of the disclosure requirements in IFRS 7 to ensure that risk disclosures by category of risk are provided in an aggregated and meaningful way for financial instruments housed in structured vehicles. Retain the non-risk related disclosure requirements about the nature and level of involvement in the Consolidation standard and include risk information, cross-referenced to the disclosure requirements in IFRS 7 and where appropriate to IAS 37 for disclosure of contingent obligations.

Option 2-Include risk disclosure requirements in relation to the nature and level of involvement in the Consolidation standard.

Staff recommendation-Option 1 due to the fact it retains all risk disclosures in one dedicated standard, IFRS 7 and it ensures that an overview of the reporting entity's exposure to off-balance sheet entities, including risk disclosures required by IFRS 7, are brought together.

Do you agree with the staff recommendation of option 1?