British Bankers' Association

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ED 7 Financial Instruments: Disclosures

Opening statement

The British Bankers' Association welcomes the opportunity to comment on ED 7 'Instruments: Disclosures'.

In broad terms, we are supportive of the strategic approach adopted in the standard. As the introduction observes, techniques used to measure and manage exposure to risks arising from financial instruments have evolved considerably and new risk management concepts and approaches have gained acceptance. We wholly concur that users of financial statements need information about an entity's exposure to risks and how those risks are managed. Indeed, we are of the philosophy that a managements understanding of risk should not only be disclosed, but may in certain circumstances be relevant to the measurement of financial instruments. Such consideration, however, are outside the scope of the consultative exercise on ED 7.

Our response to the specific questions posed in the exposure draft are set out below. Of the issues raised, we would highlight the following:

- We not support the disclosures of the fair value of collateral for most forms of loan collateral. This information would be difficult to present so as to be properly understood by users of the financial statements. (Question 2.)

- The disclosure of sensitivities is likely to require significant work to provide as proposed. (Question 3.)

- It is inappropriate for internal capital targets to be published in the financial statements. (Question 4.)

- The implementation guidance would benefit from practical examples. (Question 8.)

- The standard should explain that the liquidity risk disclosures should be based on the net liability in relation to a given financial instrument (Question 10, last point.)

<u>Issues raised in the invitation to comment</u>

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 support financial instrument disclosures being located in one Standard.
- The additional disclosures in respect of classification of financial instruments, the reconciliation of the impairment allowance and fees and expenses seem reasonable and would not be inconsistent with existing practices.

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 support the disclosures of the fair value of collateral for most forms of loan collateral. This information would be difficult to present so as to be properly understood by users of the financial statements.
- In the case of our mortgage portfolio, the disclosures would need to be expanded because it would be necessary to break down the portfolio by loan-to-value ratios and geography. The effort and detail required to make these disclosures is likely to be disproportionate to their value to users.
- The mortgage portfolio also provides an example of collateral fair values for the portfolio as a whole (potentially) being unreliable. Property valuations are typically undertaken before a mortgage is granted. While valuations might be adjusted with reference to property prices, the estimated value becomes less reliable over time.

- Disclosures about collateral are more important where there is an actual default or a high risk of default.

- In our view a better approach would be to require the disclosure of the corresponding disclosure under Pillar 3 of the Second Basel Capital Accord relating to the overall credit exposure before and after taking account of collateral pledged.

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?

- The disclosure of sensitivities is likely to require significant work to provide as proposed.

- It may be appropriate to vary the level of disclosures depending on the category of asset or liability, with perhaps less disclosure for non-trading assets and liabilities. The standard should perhaps explain this.

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?

- It is inappropriate for internal capital targets to be published in the financial statements.

- It is also inappropriate to disclose compliance with or breaches of internal or external capital requirements and their consequences.

- Capital disclosures should be limited to a quantification and description of the components of the capital base and their movements in the year.

- More detailed disclosures surrounding the existence and level of entity-specific capital requirements are not relevant to an understanding of financial position and performance or cash flows.

- We would therefore favour the requirements of the standard being restricted to the disclosures required under Pillar 3 of the Second Basel Capital Accord, ie: a qualitative statement on the bank's approach to assessing the adequacy of its capital to support current and future activities; the amount of tier 1, tier 2, tier 3 and total capital; and 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?

- We support the proposed effective date and transitional arrangements and note that we would expect many institutions to adopt the standard earlier than required.

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?

- It may be more appropriate for some information to be included in the MD&A or, for some disclosures, in a financial risk management section.
- The location of these disclosures should not cause concerns/difficulties for external auditors which could result in additional expense for entities.

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 consider that the disclosure requirements of IFRS 4 are not necessarily sufficient to highlight some of the more specialized financial risks arising in certain insurance contracts and that the need for such disclosure requirements 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?

- We consider the implementation guidance to be sufficient, but would see benefit in further examples..
- Much of the existing guidance could be incorporated into the body of the standard itself.

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 agree in broad terms, but have not yet studied this in any detail.

Question 10 – Other comments

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

General

- It would be useful to exclude subsidiaries and parent companies from providing some, if not all, disclosures when consolidated disclosures are publicly available.

Policy for determining when financial assets are no longer "past due" (paragraph 23(f))

- While this disclosure may suffice, it may be useful to require disclosure of why past due loans are considered not to be impaired (e.g. because they are fully collateralised or because they receive sufficient penalty interest, etc).

Fair value disclosure requirements (paragraph 31)

- The requirements in this paragraph should make it clear that assumptions are not relevant where market prices are used.

- Where a financial asset is measured using a valuation technique that includes assumptions that are not supportable by observable market prices or rates, then in accordance with IAS 39 the best evidence of its fair value is the transaction price. Where the transaction price has been used in the financial statements, it seems irrelevant to disclose either the fair value that has not been recognised or another fair value determined using a different alternative assumption.

Financial assets that are either "past due" or impaired (paragraph 40)

- We question whether, when financial instruments are assessed for impairment on a portfolio basis, it will be possible to provide an age analysis of those instruments that are past due as at the reporting date but not impaired.

- The indicators of impairment is more appropriately dealt with in the accounting policy rather than in the analysis proposed by this paragraph.

Liquidity risk (paragraph 42(a))

- The liquidity risk disclosures require a maturity analysis for financial liabilities showing the remaining contractual maturities. The standard should explain that this should be based on the net liability in relation to a given financial instrument and, for example, not require the disaggregation of two legs of a f/x swap. The alternative would provide a poor reflection of the commercial risk and produce a number that would be so large as to be meaningless.