EUROPEAN SAVINGS BANKS GROUP
GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
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EUROPEAN SAVINGS BANKS GROUP (ESBG)

Position Paper

on

Exposure Draft
ED 7
Financial Instruments: Disclosures

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Profile European Savings Banks Group

The European Savings Banks Group (ESBG) represents 24 members from 24 European countries representing 968 individual savings banks with around 65,000 branches and nearly 757,000 employees. At the start of 2003, total assets reached almost EUR 4,355 billion, non-bank deposits were standing at over EUR 2,080 billion and non-bank loans at just under EUR 2,195 billion. Its members are retail banks that generally have a significant share in their national domestic banking markets and enjoy a common customer oriented savings banks tradition, acting in a socially responsible manner. Their market focus includes amongst others individuals, households, SMEs and local authorities.

Founded in 1963, the ESBG has established a reputation as the advocate of savings banks interests and an active promoter of business cooperation in Europe. Since 1994, the ESBG operates together with the World Savings Banks Institute (WSBI, with 109 member banks from 92 countries) under a common structure in Brussels.

I. GENERAL COMMENTS

The European Savings Banks Group (ESBG) appreciates the opportunity afforded by the International Accounting Standards Board (IASB) to comment on the Exposure Draft *ED 7 Financial Instruments: Disclosures.*

The specific comments while highlighting the positions and problems associated with the IASB's proposal will endeavour to focus on the questions posed by the IASB in its invitation to comment and, more specifically on those issues of particular interest for our members. Beforehand, the ESBG would like to make three general comments as follows:

1) **Specificities of the banking sector**

The current project and the issuance of the Exposure Draft are welcomed by the ESBG. As a general point however, the ESBG would like to emphasize that the Exposure Draft no longer differentiates whether the information disclosed originates from a company from the manufacturing industry or credit institution from the banking sector. This is an extremely important argument for the whole discussion under ED 7 from a banking point of view as the specificities of the banking sector should also be reflected in special provisions meeting these specificities.

2) **Alignment with Basel II (CRD at the European level)**

Another argument, which is strongly interrelated with the ESBG's first general remark, is the interaction of the new Basel II framework (at a European level transposed by the Capital Requirements Directive (CRD)) and the IFRSs, mainly IAS 39 for the recognition and measurement issues and IAS 30 and IAS 32 for the disclosure requirements. It is recognised that regarding the measurement issues e.g. provisioning, IAS 39 is not in line with the current Basel II Framework (respectively the CRD proposal). The same is true for the disclosure requirements e.g. credit risk. As a consequence, banks have to prepare as a minimum, two sets of figures to meet the disclosure requirements under these two sets of provisions, which in actual fact serve similar purposes. This raises one principal question:

- Banks will always be confronted by investors, who are not able to differentiate between the two sets of figures and who accordingly wonder which set is correct.

Against this background, the ESBG would like to urge that the two sets of disclosure requirements i.e. under Basel II and under IFRSs, are converged completely when serving the same purpose or are at least made consistent in those cases when the two sets of rules are deliberately intended for different objectives. This alignment however, should ideally be completed before ED 7 is finalised.

3) Burden of increasing disclosure requirements and question of consistency

It is important to highlight that due to the significance of the banking sector, its complexity and its scope of activities, the overall burden of disclosure requirements is steadily increasing. In addition to Basel II and IFRSs, disclosure requirements for statistical or tax reporting purposes have to be taken into account. This not only produces additional costs in terms of personnel, furthermore, it does not necessarily meet the conditions and ways in which banks manage their day-to-day business. Therefore, the ESBG would like to express its concern that the various sets of disclosure requirements are not sufficiently coordinated and would lead to double-work, rather than to the intended improvements in banking transparency and efficiency. It is with this in mind that legislators, regulators, supervisors and standard setters should strive for greater consistency in disclosure requirements.

II. SPECIFIC COMMENTS

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?

ESBG Response: Overall, the ESBG agrees with these disclosure requirements for financial instruments because this information is important for investors' needs and enables every user of financial statements to understand an entity's performance as regards financial instruments. Saying this however, the ESBG would like to draw the Board's attention to the general remark under point 1).

From a more detailed perspective, the ESBG would like to highlight the following concerns:

a) Paragraph 21a of ED 7 requires the disclosure of net gains or losses on every category of financial assets and financial liabilities. The introduction of such a disclosure requirement implies an increase in work and costs for credit institutions that are disproportionate to the information gained. Therefore, the ESBG proposes deleting the respective provision completely.

b) Paragraph 21b of ED 7 refers to the determination of the income statement amounts under paragraph 21a e.g. whether the net gains or net losses include interest and dividend income. The ESBG believes that this provision could only be valid for "held for trading" transactions and suggests that the provision should be clarified accordingly.

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?

ESBG Response: Before answering the question in detail, the ESBG would like to refer the Board to its general remark under point 2). The ESBG would therefore, like to express its concern that the benefits achieved by disclosing the fair value of collaterals and credit enhancements do not outweigh the costs and efforts undergone while determining the fair values. Concretely, the ESBG accordingly proposes aligning the disclosure requirements for collaterals and other credit enhancements to the existing requirements under Basel II (respectively under the CRD proposal). These disclosure requirements are the following under the Commission's proposal for a CRD (see Annex VIII Part 1 Point 1.3 of the current CRD proposal as published on 14 July 2004):

- total gross credit risk exposures,
- policies and processes for collateral valuation and management,
- description of the main types of collateral taken by the bank,
- description of the main types of guarantor counterparty and their creditworthiness,
- total exposures that is covered by collaterals,
- total exposure that is covered by guarantees or credit derivatives,
- total exposure securitized by the bank,
- amount of impaired loans and, if available, past due loans, including the amounts of allowances,

- reconciliation of changes in the allowances for loan impairment.

The Basel Framework foresees a similar disclosure requirement (see Pillar III Table 7 on credit risk mitigation).

The minimum disclosures on credit risk are laid down in paragraphs 39 et seq. of ED 7. Paragraph 39b states that an entity shall disclose by class of financial instrument with credit risk *in respect of the amount disclosed in a), a description of collateral pledged as security and other credit enhancements and, unless impracticable, their fair value....* The term "unless impracticable" should be further clarified and could be used as a means to align the current disclosure requirements under ED 7 to the disclosure requirements under Basel II (respectively the CRD proposal). Accordingly, the clarification should be used for the other paragraphs as well, in which the term "unless impracticable" is used (see e.g. paragraph 40c).

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?

ESBG Response: The ESBG has serious doubts as to whether the proposed sensitivity analysis will really provide the users of financial statements with the intended information. First of all, the tool itself should be questioned from a mathematical point of view: Is it the best tool to reflect exposure to market risk (question of dimension)? Second, the need to disclose information is in conflict with the need to keep certain types of information confidential. The ESBG is therefore convinced that the provision of information via the tool of a sensitivity analysis may exceed its original idea of disclosing exposure to market risk and may open up information which should be kept internal and confidential from third parties e.g. competitors, who could utilize this in an uncompetitive manner.

In this respect, the ESBG would like to stress the importance of maintaining Value-at-Risk (VaR) values, which are already widely adopted by credit institutions to estimate their market risk. These values have the advantage that they are not as sensitive and not as "competition-driven" compared to a sensitivity analysis. From a calculation point of view, the ESBG would like to draw attention to the fact that these values should only be computed at the level of the exposure as a whole as opposed to the level of each individual position of the financial statements.

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?

ESBG Response: As already pointed out in the case of credit risk, for credit institutions, which are already under severe supervision (e.g. according to Directives 2000/12/EC, 2004/39/EC and 93/6/EC), the designed capital disclosures as envisaged by ED 7 would directly result in double work and double figures. To avoid confusion among users and to prevent questions from the side of the auditors, the ESBG would invite the IASB to revise and align the current capital disclosure requirements with the current capital disclosure requirements as drafted by the Basel Committee. The ESBG is convinced that, – as these disclosure requirements fulfil the needs of regulators and supervisory authorities, this should be also the case for all other interested users of a bank's financial statement. Instead of requiring disclosures on:

- qualitative information about the entity's objectives etc.,
- quantitative data about what the entity regards as capital,
- capital targets set by management etc.,

the disclosure requirements should be replaced by the capital disclosure requirements as currently foreseen under the Basel II Framework (respectively CRD Art 56 "definition of own funds" according to the draft document published by the EC on 14 July 2004) as follows:

- summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities,
- Tier 1, Tier 2, Tier 3 and total capital, and
- deductions from capital.

At the same time it has to be clear and should be pointed out that the definition of capital is still under discussion under the Basel II Framework as well. In this context the ESBG would like to quote paragraph 17 of the Basel Committee Publications No. 107 - June 2004: 17. "*One area where the Committee intends to undertake additional work of a longer-term nature is in relation to the definition of eligible capital. One motivation for this is the fact that the changes in the treatment of expected and unexpected losses and related changes in the* *treatment of provisions in the Framework set out here generally tend to reduce Tier 1 capital requirements relative to total capital requirements. Moreover, converging on a uniform international capital standard under this Framework will ultimately require the identification of an agreed set of capital instruments that are available to absorb unanticipated losses on a going-concern basis. The Committee announced its intention to review the definition of capital as a follow-up to the revised approach to Tier 1 eligibility as announced in its October 1998 press release, "Instruments eligible for inclusion in Tier 1 capital". It will explore further issues surrounding the definition of regulatory capital, but does not intend to propose changes as a result of this longer-term review prior to the implementation of the revised Framework set out in this document. In the meantime, the Committee will continue its efforts to ensure the consistent application of its 1998 decisions regarding the composition of regulatory capital across jurisdictions."*

As such, as an intermediate solution for banks, the ESBG proposes that for disclosure requirements under ED 7 the current disclosure requirements under Basel II may be used. At the same time, the long term aim should be the convergence of the definitions i.e. that the IASB and the Basel Committee agree on a common definition of capital for credit institutions and investment firms.

That being said, the ESBG would like to express its strong rejection of the following disclosure requirements as currently proposed in ED 7:

a) Paragraph 47d of ED 7 requires the entity to disclose whether during the period it complied with the capital targets set by management. Internal capital targets defined and set by management should not be part of external disclosure requirements and consequently should not be published in the financial statements. The ESBG therefore, asks for complete deletion of this part of the subsection without any replacement.

b) Paragraph 47e of ED 7 foresees that when an entity does not comply with the capital targets set by management or the externally imposed capital requirements to which it is subject, it should disclose the consequences of such non-compliance. In this case also, the ESBG is convinced that such a disclosure requirement is inappropriate as it only applies to financial institutions, which are already exposed to a severe regime implemented by regulators and supervisors, in which appropriate sanctions are foreseen. The proposed disclosure requirement would only add additional work and expenses to the already existing workload of banks. This provision should accordingly be deleted completely.

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?

ESBG Response: Paragraph 49 in connection with BC62 encourages earlier application of ED 7, meaning before 1 January 2007 and introduces a relief for first time adopters. The ESBG would recommend the widening of the scope of the relief for first time adopters to all kinds of entities due to the burden of preparing comparative figures; this burden is the same for all companies regardless whether they are first time adopters or not.

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?

ESBG Response: The ESBG believes that disclosures of risks should be developed according to the users' needs. First of all, the disclosure requirements have to be differentiated according to external (e.g. investors) and internal (e.g. management) users. These two broad groups of disclosure requirements should not be mixed. Depending on the user, the need for information and the need on decision taking on the basis of the information disclosed are very different. The ESBG would therefore like to differentiate between external disclosures, which should be included in the financial statements and internal disclosures, which should not be included in the financial statements but – as currently done in many countries – in the management report.

To avoid unnecessary risk reporting in the short term, the ESBG suggests maintaining the current risk reporting regime as envisaged by Directive EEC/86/635 (see wording article 44 (1) of EEC/86/635) and implemented accordingly at national level. The whole topic should be revised in the IASB's project on the Management Discussion and Analysis without pre-empting it beforehand.

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

ESBG Response: no comments.

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?

ESBG Response: The ESBG would recommend the IASB to complement the Implementation Guidance with additional more comprehensive examples i.e. not only one for a non-financial institution, but also one for a financial institution.

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).

ESBG Response: no comments.

Question 10 – Other comments

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

ESBG Response: The ESBG would like to provide the IASB with further comments on the following points:

- disposal of participations,
- liquidity risk,
- inclusion of disclosures of subsidiaries, and
- definition of prepayment risk.

First, paragraph 30d of ED 7 stipulates that – under the conditions described – the extent of possible differences between the carrying amount of such financial assets and financial liabilities and their fair value, including information about whether and how the entity intends to dispose of the financial instruments should be disclosed. The ESBG considers the disclosure of the disposal of participations, which are qualified as financial assets, as inappropriate. This subsection should therefore be deleted.

Second, paragraph 42a stipulates that in order to clarify the liquidity risk, a list of liabilities must be made that shows the remaining contractual maturities. The liquidity risk cannot be reflected through an exclusive analysis of liabilities that shows the remaining contractual maturities. Alternatively, there should be the option of presenting the liquidity risk on the basis of liquidity ratios which are already used for prudential supervision law purposes.

Third, observing that the definitions regarding consolidation are different under the Basel II Framework from under IFRSs, the ESBG would dismiss the inclusion of disclosure requirements for subsidiaries because this would directly result in double work.

Fourth, the definition of prepayment risk under Appendix A should be revised as well. For the moment the definition reads *The risk that the counterparty to a financial asset will repay other then when expected.* Early repayment does not constitute a risk if it is conditional on the payment of a full yield maintenance fee. This fact should be considered and the definition refined accordingly to: *The risk that the counterparty to a financial asset will repay other then when expected, without paying a full yield maintenance fee.*

III. CONCLUSION – CONSISTENCY WITH IDEAL OF CONVERGENCE

Finally, the ESBG would like to emphasize again the importance of ensuring that the disclosure requirements for credit institutions under Basel II and under IFRSs need to be synchronised thereby creating one consistent set of disclosure requirements under which credit institutions have to report. This means that for situations where the two sets of provisions have the same intentions they should be converged completely and where the two sets of provisions differ in their objectives, as a minimum consistency should be ensured by the IASB and the Basel Committee by drafting adequate provisions.

The ESBG calls for the convergence and consistency of the Basel II Framework and IFRSs not only at the level of disclosure requirements, furthermore with respect to issues of recognition and measurement.