European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

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Comments by the EACB regarding the IASB's Exposure Draft 7 Financial Instruments: Disclosures

GENERAL REMARKS:

The European Association of Cooperative Banks (EACB)[1] is pleased to submit its comments on the Draft Standard "ED 7: Financial Instruments: Disclosures". Basically, we endorse IASB's goal of reviewing the existing disclosure rules for financial instruments on the basis of more recent developments in the field of accounting and risk management and jointly pooling them with complementary rules on risk reporting in a systematic manner into one standard.

ED 7 should *inter alia* replace the existing IAS 30 which, due to IAS 30's industry specific disclosure obligations for credit institutions and similar financial institutions is explicitly geared towards the peculiarities of the business activities and the corporate structure of the latter. In this capacity, IAS 30 has thus also exerted a decisive impact on those disclosure and structuring formats of credit institutions which are a common practice. IAS 1 is not industry specific, i.e. it does not contain any provisions on the presentation of a financial statement which would specifically relate to the business activity of banks and similar financial institutions. It is therefore our understanding that after the abrogation of IAS 30, use of the established reporting formats and balance sheet structures will remain legitimate.

We welcome the fact that the present standard draft predicates the scope and type of the information that needs to be disclosed on the use of financial instruments by the respective companies and also on the scope of the risks associated with the latter. This way, the individual corporate conditions in meeting the disclosure obligations are adequately taken into account. At the same time, we would like to point out that the presentation of risks from financial instruments which is the approach preferred by IASB, is a product based risk specification which in our view, does not adequately take into account the risk mitigating correlation effects and which, besides, is frequently not in line with practices on the ground of credit institutions' internal risk management.

Furthermore, we feel that a consistency between the disclosure obligations under ED 7 and the disclosure requirements under the new capital adequacy provisions stipulated by the Basel Committee for Banking Supervision (i.e. Basel II, Pillar 3) has not or, moreover, cannot be achieved in certain respects. Whilst ED 7 is primarily predicated on financial instruments, Basel II, Pillar 3 calls for information on the risk structure notably of loan transactions and the

[1] The European Association of Co-operative Banks represents over 4.500 co-operative credit institutions active in all the EU Member states and serving over 100 Million customers. Its member organisations are decentralised national networks of small-sized Co-operative banks' networks, which have a strong presence on a local or regional level. They account for a large part of the SME and private household credit market (17%) and thus play a crucial role within the Internal Market.

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composition of the equity capital base of credit institutions. Apart from this, many of the provisions are based on different consolidation scopes.

We would like to submit the following answers with regard to the individual questions:

DETAILED REMARKS:

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 BC 13).
(b) information about any allowance account (see paragraphs 17 and BC 14).
(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC 16).
(d) fee income and expense (see paragraphs 21(d) and BC17)

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

The disclosure proposed under Question 1 (b) is justified. However, it involves a distortion of disclosure between entities which will choose to use an allowance account (with an aim of best follow-up) and those which will choose to write-off directly the carrying amount of the financial asset.

Due to different valuation provisions for the various classifications of financial instruments defined under IAS 39, we feel that a disclosure in the notes which is predicated on these classifications is, on principle, appropriate. Indent 10 proposes a breakdown and disclosure of the carrying amounts of financial assets and liabilities as per IAS 39 classification; in terms of feasibility, this involves a reasonable cost-benefit ratio.

We do, however, have doubts as to the approach adopted under indent 11 (a), i.e. the requirement to provide information on value changes which may be attributable to interest rate risk.
In order to separate them from value changes due to the change in the captive creditworthiness, we advocate in favour of reporting value changes deriving from certain market risks in a separate manner. In order to meet this goal, however, there is a need for separate statement of value changes from *all* market risks. Hence, we advocate in favour of

separately reporting value changes that are market risk induced and that are not induced by interest rates.

The requirement contained under indent 21 (a), i.e. the disclosure of net gains or losses for each classification on the basis of the underlying financial assets and liabilities, involves an excessive additional effort for companies. This effort is not offset by a tangible amount of benefit due to the resulting additional insight. We thus propose deleting the requirement under indent 21 (a) completely.

Indent 21 (b) stipulates that there needs to be a disclosure as to how the income statement amounts mentioned in (a) are determined, for example, whether the net gains or net losses include interest and/or dividend income. In our view, this can only relate to trading transactions. We therefore recommend a corresponding limitation of this provision to "held-for-trading" transactions.

The disclosure obligation pursuant to indent 30 (d), in our view, is partly inappropriate. Particularly in cases of shareholdings which are reported on the balance sheet as a financing instrument, this provision would be excessive. We therefore propose deleting this requirement.

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

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC 27 and BC 28).

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

No comment

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC 36-BC 39).

Is the proposed disclosure of a sensitivity analysis practicable for all entities?

If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

Sensitivity analyses on a bank's portfolio are, already today, an important part of the risk management of many companies. Such analyses provide information on which impact may result on the fair value of financial instruments and thus on the profit and loss or, moreover, on equity capital from potential changes of a risk variable. This notwithstanding, we would like to point out that the results from the sensitivity analyses may contain confidential information the disclosure of which may result problematic from the point of view of competition.

Against this backdrop, we explicitly welcome the fact that the value-at-risk ratios may be used for coverage of the requirements of this standard draft. They are already being used by the majority of credit institutions for measurement of the market risk and they are generally less sensitive in terms of competition than (conventional) sensitivity analyses. In addition to this, value-at-risk ratios are already required in order to comply with the disclosure obligations under the Basel Framework agreement. By way of clarification, in this context we would like to point out that the value-at-risk ratios should only be presented as overall exposure (i.e. not at the level of balance sheet items), since this is the only way of using analyses from the risk management.

In other respects, we welcome that disclosures about the effective rate on financial assets and liabilities be no longer required.

Question 4 – Capital disclosures

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

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

The present Draft Standard contains a host of disclosure obligations on a company's "capital". In our understanding, indent 46-48 requires information on the "equity capital of a company". Should this not be the case, we kindly suggest providing a concept clarification of the terms "capital" and "equity".

The disclosure obligations on capital *inter alia* also cover the presentation of external capital requirements which are particularly germane to the credit industry. Here, ED 7 does not call for any quantitative information on prudential supervision capital adequacy requirements. This notwithstanding, the publication of violations and the prudential supervision measures associated with this may have a lasting and negative impact on the relation between the competent supervisory authority and the respective company. Hence, on principle, there should be no obligation to disclose such information.

Neither should there be an obligation to disclose quantitative information on management's internal capital goals since such data only represents the companies budgeted in-house figures which should not become the subject of external reporting obligations. On the foregoing grounds and in order to prevent misleading conclusions, we also doubt that it would be appropriate to disclose over- or underachievement of internal capital goals as well as their consequences.

As a complementary note, we would like to point out that the issue of the definition of the term equity capital for accounting purposes has re-emerged in this context. In the past, the same issue already emerged during the debate on the paid-up society shares in cooperatives in the context of IAS 32. In our view, IASB should also deal with the capital paid in by the partners in trading partnerships and shares in dormant partnerships which, under the philosophy in continental Europe may, under certain preconditions, qualify for equity capital that has to be reported on the balance sheet.

<u>Question 5 – Effective date and transition</u>

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?

Under the proviso that the envisaged IFRS 7 is being adopted during the year of 2005, we generally feel a mandatory application for fiscal years starting after 1 January 2007 is appropriate. We also welcome the possibility of potentially earlier application of the planned IFRS. Yet, the transition provisions proposed under ED 7 merely provide a waiver for presentation of the comparative disclosures in the event of IFRS first-time adopters who apply the standard prior to 1 January 2006.

A retroactive calculation and presentation of comparative information is generally problematic since the corresponding data are either not at all present in the company or their collation would be associated with a disproportionately high amount of effort. This does not only relate to IFRS first-time adopters but also to companies which already prepare their balance sheets under IFRS. We would therefore welcome an extension of the transitional regime to include these companies which already prepare their balance sheet pursuant to IFRS. In addition to this, a transitional regime which would be valid until the mandatory application deadline would increase the incentives for an earlier and voluntary adoption of the standard. Hence, the proposed transitional regime should be extended in scope, so that each and any company which will apply the standard before 1 January 2007 on a voluntary basis may refrain from presenting comparative information.

<u>Question 6 – Location of disclosures of risks arising from financial instruments</u>

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

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

We subscribe to IASB's view that the disclosure obligations on risks from financial instruments form part of the financial reporting.

In order to prevent negative effects of a redundant risk reporting, however, we propose a derogation clause which allows meeting the respective disclosure obligations in the management report. The latter is mandatory under European Law and involves the publication of a risk report. The information should not be published in the form of an annex.

<u>Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)</u>

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57–BC61.

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

We agree with the necessity to amend the risk disclosures in IFRS 4 in order to make them more consistent with the requirements of the draft IFRS. However, we consider that it will be preferable to propose those amendments within the phase II of the Insurance Project.

<u>Question 8 – Implementation Guidance</u>

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?

From our point of view, it would be helpful to provide an example for the calculation of the change in the fair value of a financial liability which is not due to a change in the reference interest rate (cf. ED 7.12) and additionally including said information in the Implementation Guidance.

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?

Notwithstanding our comments on the Draft Standard, we feel that the disclosure obligations proposed under ED 7 on fair value are appropriate in comparison to those of the FASB Draft Standard.

Question 10 – Other comments

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

As a general remark, this ED requires too much information, which is susceptible to misunderstanding. Ideally, the Board would have to determine only some general axes of information and not a checklist of disclosures.

As regards detailed remarks, we would state the following:

Indent 30 (d) and (e) stipulate the need to provide information on any disposal plans and on any gains. We feel that these disclosure obligations are too far-reaching, since they incur the danger of a breach of trust in relation to other business partners giving rise to ensuing corporate disadvantages.

It is our understanding that the list and differentiation of the risk types pursuant to indent 33 is non-exhaustive and only serves illustration purposes and that it may be possible to stipulate further risk types. Furthermore, it is not taken into account that part of the risk or individual risk types will also arise outside of financial instruments and that correlation effects will have a risk mitigating effect. In our view, additional explanation is required in this regard.

For a measurement of the market price risks in the field of banking, typically value-at-risk models are being used which already take into account concentration risks via model parameters and express the latter in the risk ratio. We therefore feel that a separate presentation of concentration risks will be dispensable. Against this backdrop we advocate for a corresponding qualification under indent 38.

Pursuant to indent 39 (IG 17(c)), information needs to be given on historical default rates. Yet, these figures do not provide the user with any information on future defaults. We therefore propose deleting this requirement.

Concerning indent 39-41, we propose a clarification that, based on the application of the management approach pursuant to BC 22, credit institutions may use the loan concept which is also applicable for the purposes of disclosure under Basel II, Pillar 3 and for the internal reporting.

The disclosure obligations pursuant to indent 40 should merely extend to the overall exposure of financial assets. An excessively high additional effort would particularly occur in the event of an analysis of "past due" or "impaired assets" at the level of balance sheet items. Such a requirement would bear no meaningful relation to the resulting insight that might be gained and should not be stipulated.
In this context we would also like to point out that for the recipient of the financial statement, the analysis of the age of financial assets that are past due requested under indent 40 (a) in our view does not provide any value added in terms of information. We therefore propose deleting this requirement.

Indent 42 (a) stipulates that in order to clarify the liquidity risk, a list of liabilities must be made that shows the remaining contractual maturities. Since the liquidity risk cannot be reflected through an exclusive analysis of liabilities that shows the remaining contractual maturities, alternatively, there should also be the option of presenting the liquidity risk on the basis of liquidity ratios that are accepted under prudential supervision law.