

Accounting for change: transparency in the midst of turmoil*

A survey of banks' 2007 annual reports

August 2008



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Foreword

The introduction of IFRS in Europe in 2005 represented the greatest shake-up in financial reporting in modern times. PricewaterhouseCoopers' 2006 survey 'Accounting for change: A survey of banks' 2005 IFRS annual reports' summarised the extent to which the introduction of IFRS changed the way that banks report their results. Since then, events in the financial markets have placed banks' reporting under significant scrutiny.

The media, shareholders and analysts have been asking detailed questions as to the transparency and consistency of application of accounting standards. Valuation methodologies, the use of unobservable parameters, exposure to structured finance activities and the level of disclosure and understanding in the market of a bank's financial risk management strategies have all come under intense focus.

The turmoil in the credit markets over the last year has raised many questions as to the effectiveness of the current accounting and disclosure frameworks. As such, we decided, to investigate the extent to which the current model has delivered consistency and transparency in financial reporting in this difficult environment.

This survey reviewed the financial statements of 22 banks, providing a representative cross-section of global banks by size, diversity of operations and geographical spread. They also provide a mix of SEC and non-SEC registrants as well as certain US GAAP preparers. This survey focused on the following areas, which we believe are most directly affected by the market dislocation:

- Risk management disclosures
- Fair value measurement and disclosures
- Disclosures of structured finance activities

In addition to assessing how well the current accounting and disclosure guidance stood up to the challenges of the recent market conditions, the survey also enabled us to make some suggestions as to how certain disclosures could be improved upon to increase the level of transparency and consistency in banks' financial reporting.

We trust that this survey will be both interesting and useful when producing your financial reports. Please do not hesitate to contact us if you would like to discuss any points raised in this survey.

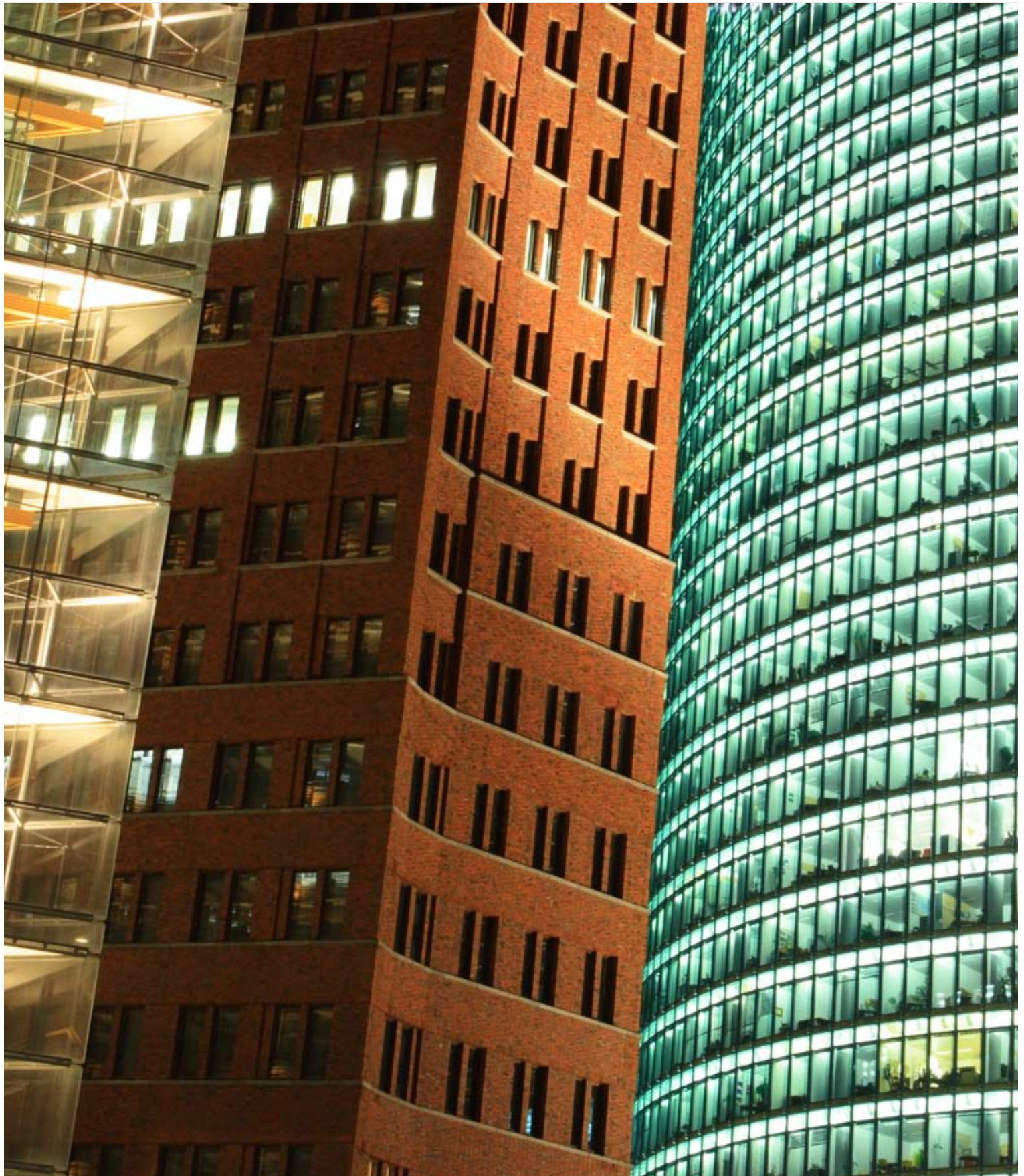


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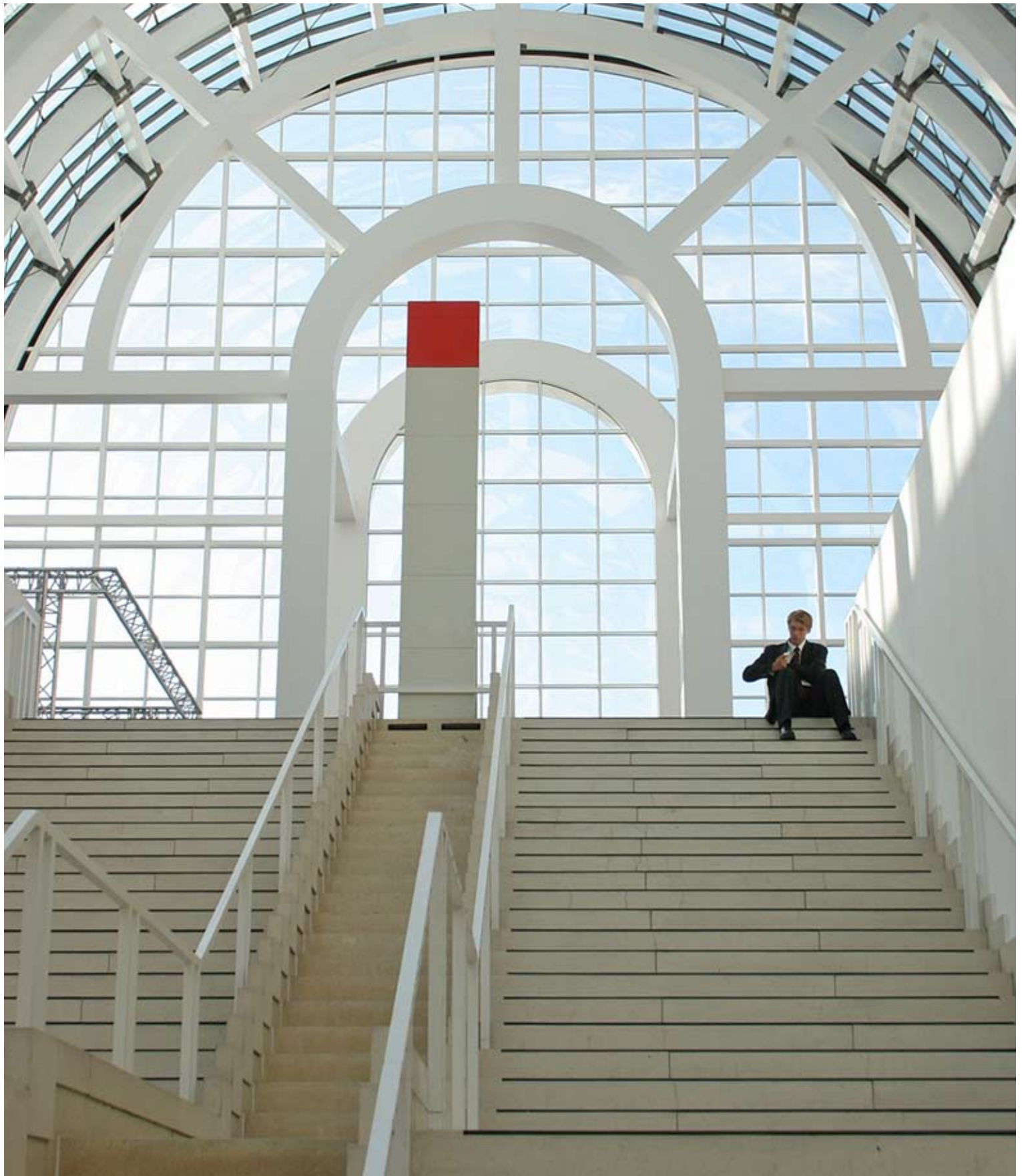
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Partner, Global Accounting Consulting Services

1. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.



Banks surveyed

Bank	Abbreviation	Web address
Bank of America	Bank of America	www.bankofamerica.com
Bank of China	BOC	www.boc.cn
Barclays	Barclays	www.barclays.co.uk
BBVA	BBVA	www.bbva.com
BNP Paribas	BNP Paribas	www.bnpparibas.com
Citigroup	Citi	www.citigroup.com
Commonwealth Bank of Australia	CBA	www.commbank.com.au
Credit Suisse	Credit Suisse	www.credit-suisse.com
Danske Bank	Danske Bank	www.danskebank.com
DBS	DBS	www.dbs.com
Deutsche Bank	Deutsche Bank	www.db.com
Dresdner Bank	Dresdner Bank	www.dresdner-bank.de
HSBC	HSBC	www.hsbc.com
ING	ING	www.ing.com
JPMorgan Chase & Co.	JPMorgan Chase	www.jpmorganchase.com
Lloyds TSB	Lloyds TSB	www.lloydstsb.com
Nordea	Nordea	www.nordea.com
Rabobank	Rabobank	www.rabobank.com
The Royal Bank of Scotland	RBS	www.rbs.com
Société Générale	Société Générale	www.socgen.com
Standard Bank	Standard Bank	www.standardbank.co.za
UBS	UBS	www.ubs.com



Executive summary

In our 2005 survey we took a critical look at the impact of the implementation of International Financial Reporting Standards (IFRS) on the financial reporting for 20 banks. The current survey revisits the 2007 financial statements for a number of these banks to perform a targeted review of disclosures around fair value, structured finance, and risk management. Fair value and risk management disclosures are of particular interest given the adoption of SFAS 157 *Fair Value Measurements* and IFRS 7 *Financial Instruments: Disclosures* in the intervening period and the scrutiny placed on such disclosures by investors and regulators as a result of the recent market turmoil.

The turmoil has also served as a catalyst to question the adequacy of disclosures relating to structured finance activities. Due to tightening of the short-term money markets, a number of off-balance sheet conduits and structured investment vehicles have fallen into administration or required rescue packages from their sponsoring bank. The industry-wide multibillion dollar write-downs of complex structured products that were often housed and financed in these off-balance sheet vehicles have provided further impetus for regulators to take a fresh look at the valuation and disclosures of on- and off-balance sheet structured finance activities.

As a result, in October 2007, the G7 Ministers and Central Bank Governors asked the Financial Stability Forum (FSF) to undertake an analysis of the causes and weaknesses that have produced the turmoil and to set out recommendations for increasing the resilience of markets and institutions going forward. In its April 2008 report, *Enhancing Market and Institutional Resilience* the FSF recommended that the International Accounting Standards Board (IASB) improve the accounting and disclosure standards for off-balance sheet vehicles; and improve the guidance and disclosures about valuation methodologies and the uncertainty associated with valuations.

Our 2007 survey population consists of 22 banks reporting under both IFRS and US Generally Accepted Accounting Principles (US GAAP). In presenting our results we have focused on identifying problematic areas and highlighting examples of 'best practice' disclosures to consider what information would enhance market participants' understanding of the banks' activities in these areas. Given the differing regulatory bodies that govern and define the disclosure requirements of the surveyed banks, we recognise that not all examples included in this publication are directly applicable to every bank.

Fair value

Recent events have created heated debate on the merits of fair value as a financial reporting measure. Those opposed have argued that, in the presence of illiquid and unstable markets, fair value measurements are subjective and difficult to validate, create unintended income statement volatility and serve to exacerbate the effects of liquidity crises – as banks are required to revalue their assets at depressed prices, mark-to-market losses reduce capital reserves and can lead to ‘fire sales’ of remaining assets and, potentially, further write-downs.

Proponents of ‘fair value’ have countered by pointing out that it represents the most transparent, easy-to-understand, and relevant measure available. They argue that the multibillion dollar fair value write-downs reported by a number of banks since the turmoil began are a reflection of the economic reality of current market conditions. The main catalysts for these conditions have been relaxed underwriting practices and a lack of market discipline, as opposed to an accounting methodology.

In our 2005 survey we found that the nature and extent of disclosures relating to fair value accounting varied widely and that there was a lack of transparency around the valuation techniques applied, and the sensitivity of estimates to changes in key inputs to valuation models. In the intervening period, the implementation of IFRS 7 and SFAS 157, along with the fallout from the market turmoil, has reinvigorated the fair value debate and to varying degrees had a positive impact on the nature and extent of fair value disclosures.

We noted an overall increase and improvement in disclosures on the use of fair value. This was particularly evident in those areas most impacted by the turmoil and where the banks discussed valuation techniques using significant unobservable parameters. There was also an increase in the disclosures on credit and liquidity risks, and the impact of changes in these variables on valuations.

Our analysis also identified a number of areas where we think fair value disclosure practices could be further improved:

- Disclosures of valuation methodologies could be more comprehensive and provide more detailed discussion of underlying assumptions used and how these change under different market conditions.
- Banks should provide quantitative disclosures on fair value methods and the impact of unobservable inputs to the income statement – these were not provided by all banks, generally varied in format and often lacked explanation of approach and assumptions used.
- Disclosures addressing the fair value of financial instruments not carried at fair value were vague and often did not provide insightful analysis of the underlying valuation process or the drivers of resulting differences between fair value and carrying amount.

In the middle of the fair value debate, and with greatest ability to effect change, are the international standard-setters and regulators. The IASB and the US Securities and Exchange Commission (SEC) have reiterated their support of fair value and continue to debate potential improvements to current guidance. In particular, updates on proposed amendments to IFRS 7 fair value disclosure requirements are expected by the end of the year. Our view is that fair value continues to represent the best available methodology for determining and reporting the value of financial instruments. Work on improving related disclosures, however, needs to continue to ensure that there is transparency on how fair value guidance is applied.

Structured finance

Recent market events have served to highlight shortcomings in the current regulatory framework and have placed structured finance firmly at the top of international policy-makers' agenda. The IASB, SEC, Financial Accounting Standards Board (FASB), Basel Committee on Banking Supervision (BCBS) and Economic and Financial Affairs Council (ECOFIN) have all announced initiatives focused on the review of existing regulations relating to structured products and treatment of off-balance sheet entities.

We concluded in the 2005 survey that the range and depth of structured finance-related disclosures were limited and generally did not present a comprehensive view of banks' structured finance activities and their component risks. In the current survey we noted an improvement due to the addition of new disclosures focusing on the activities and related structures impacted by recent market events (e.g. SIVs, CDOs, etc.). However, this improvement varied among the surveyed banks and disclosure relating to those activities less affected by the market turmoil remained relatively unchanged.

In general, the disclosures around the type, extent and complexity of structured finance activities remained diverse. Certain banks provided detailed, tailored quantitative information, including on- and off-balance sheet analysis, as well as funded and committed lines; others provided only brief qualitative information on one activity or, in some cases, no information at all. Financial statements users may therefore still find it difficult to fully assess the exposure and risks related to banks' structured finance activities.

In our report we highlight a number of potential disclosure enhancements that, in our view, would significantly enhance transparency. Many of these recommendations are of a similar nature to those noted in recent reports issued by the FSF, Senior Supervisors Group (SSG) and Committee of European Banking Supervisors (CEBS). It will be interesting to observe how these recommendations shape revisions to guidance in coming years. As part of this process, care will need to be taken to ensure that the introduction of additional guidance, aimed at improving transparency, does not result in onerous and superfluous disclosure requirements that overwhelm the reader and ultimately mask banks' true risk exposure.

Risk management

We concluded in our 2005 survey that there was a general lack of transparency around the nature and extent of risk being managed by the surveyed banks. It was widely anticipated that the implementation of IFRS 7 would significantly enhance the quality of disclosures in this area. In his introduction to the new standard, IASB chairman Sir David Tweedie said: 'The Board believes that the introduction of IFRS 7 will lead to greater transparency about the risks that entities run from the use of financial instruments. This, combined with the new requirements in IAS 1 *Presentation of Financial Statements* will provide better information for investors and other users of financial statements to make informed judgements about risk and return.'

The results of our survey indicate that the implementation of IFRS 7 did not result in an immediate improvement in the transparency of risk management disclosure. Most of the banks in the survey did not take the opportunity to present a truly comprehensive and clear picture of how they manage risk, opting instead to focus on achieving compliance with IFRS 7 minimum requirements. Many of these minimum requirements, particularly those which were quantitative in nature, were not aligned with how the banks managed the related risk. The result was a disjointed set of disclosures that did not tell a clear story or fully harmonise with the 'through the eyes of management' principle that the IASB advocated.

It is clear that the implementation of IFRS 7 has been challenging. The significant level of operational and system enhancements inherent in compiling the first year of IFRS 7 information may have limited the effectiveness of risk management disclosures in 2007 annual reports. Some of the interpretations of the standard were in fact far wider than originally expected and could have resulted in certain banks staggering their implementation of the standard over a number of periods and defaulting to a minimum-requirements disclosure approach in the first year of adoption, with the intention of refining and expanding disclosure in subsequent periods.

Industry pressure and the implementation of Basel II Pillar 3 requirements for a number of European banks are also likely to have a positive impact on the quality of risk management disclosure in the immediate future. Banks are also likely to adopt a more strategic and robust approach to preparing their disclosures as they become more comfortable explaining sensitivities and risk appetites, and are able to benchmark against their peers. The process, however, is clearly an evolving one and it will take time for consensus to be reached on the approach to risk management disclosure.

Conclusion

The implementation of new financial reporting standards around risk management and fair value measurement and disclosure has coincided with a period of severe volatility in the most advanced financial markets. In the midst of the market turmoil, widespread scepticism around the soundness of banks' risk management, valuation and disclosure practices has had a negative impact on investor confidence and has served to heighten liquidity pressures in funding markets.

In its principles-based, 'through the eyes of management' approach to IFRS 7, the IASB has placed the onus on banks to be proactive and robust in their approach to financial instrument disclosures. It has provided them with the flexibility to disclose information that is most relevant to market participants, given current market conditions. For the most part, banks have responded by attempting to reinvigorate and expand their disclosures in a number of areas most impacted by the turmoil. This has produced mixed results. While there has been an overall improvement in the quality and breadth of disclosures compared to our previous survey, the level of improvement varied significantly across the surveyed banks. In many instances, additional quantitative and qualitative disclosures were not adequately linked to tell a coherent story about the bank's performance and did not result in greater transparency. Disclosures in areas less affected by the turmoil have also remained largely unchanged from previous years.

It is clear that the current diversity and limitations in disclosure practice, as echoed by proposals from regulator and user groups such as the FSF, is likely to result in much needed enhancements to current guidance in the near future. Banks are also likely to improve their reporting processes and related controls across these areas as they become more comfortable with the requirements of the new standards and build upon the lessons learned from the turmoil. As disclosure practices and processes continue to evolve, the manner in which best practice consensus is reached by these groups will largely determine the ultimate impact of recent events on the future transparency of financial reporting.



Fair value

1.1 Overview

The use of fair value and the adequacy of related disclosures have come under significant scrutiny over the past 12 months. New disclosure guidance implemented in the US and under IFRS, in conjunction with the 'credit crunch', has intensified debate on the role of fair value.² While many view fair value as the most transparent method of measuring financial instruments and the best indicator of a firm's present condition,³ some suggest that it is compounding market instability as existing guidance requires reference to current market prices, even in abnormal market conditions, and that this can increase income volatility.² Accounting standard-setters and certain regulators, however, have reaffirmed their support for fair value as it is used today.⁴

While stakeholders express different views as to the role of fair value in current market conditions, all, including the IASB, appear to agree that there is a need for increased transparency through enhanced disclosures.⁵ The SEC highlighted the importance of improving fair value disclosures through recent speeches⁶ and comment letters delivered to public companies. A recent report issued by the FSF⁷ analyses the causes and weaknesses that have led to the current financial market turmoil and sets out recommendations for increasing the resilience of markets in the future. Specific to valuation, it recommended that institutions should:

Enhance the quality of their disclosures about valuations, valuation methodologies, price verification processes and the uncertainty associated with valuations.

In the light of demands for more transparency, we noted that fair value disclosures have been expanded compared to our previous survey, in both granularity and breadth. Although the introduction of IFRS 7 did not significantly change existing fair value disclosure requirements, it did prompt banks to revisit their overall presentation and scope of disclosures. Demands for more disclosure have also been driven by market conditions, in conjunction with the market's reaction to the implementation of new fair value reporting and disclosure requirements in the US.

While these increased disclosures have provided useful information, we observed that diversity in application and often limited explanation of approach and assumptions in certain areas reduced the comparability and insight that could have been achieved in applying the IFRS 7 requirements.

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2. The International Monetary Fund (IMF) World Economic and Financial Surveys, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness* – April 2008.
 3. The CFA Institute Centre for Financial Market Integrity – 17.03.2008.
 4. IASB Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, paragraph IN5: 'A long term solution to address such measurement-related problems is to measure the same way all financial instruments within the scope of a standard for financial instruments. Fair value seems to be the only measure that is appropriate for all types of financial instruments. However there are issues and concerns that have to be addressed before the boards can require fair value measurement. It might take a long time to resolve these issues and concerns.'
 5. IASB, *ibid.*, paragraph 2.2 'In the intermediate change [to fair value measurement requirements]... should provide more relevant information and more easily understandable information for users.'
 6. The SEC, 'Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments' – December 2007.
 7. The FSF, *Enhancing Market and Institutional Resilience* issued to the G7 Ministers and Central Bank governors – 07.04.2008.

Our survey considered the following criteria in assessing whether expanded disclosures at the year-end have provided enhanced transparency and insight on how fair value is used:

- Disclosure of valuation methodologies and the significant underlying assumptions and judgements involved;
- Disclosure of fair values by valuation method and observability of underlying inputs, as well as impacts of unobservable inputs;
- Disclosure on application of the Fair Value Option (FVO) in terms of the rationale and criteria of election;
- Fair value disclosures for items not carried at fair value for the differences between their fair value and carrying value;
- Disclosure of accounting treatment for deferred Day 1 profits and losses and their movement during the period;
- Disclosure on governance and controls over the fair valuation process.

This chapter focuses on the extent to which the surveyed banks' fair value disclosures have met the above criteria. Examples of perceived best practice are highlighted, as well as areas for improvement.

1.2 Disclosure guidance

The financial reporting framework against which we assessed the overall transparency, quality and consistency of fair value disclosures includes the requirements of IFRS 7 as well as relevant SEC guidance:

IFRS 7 requires disclosure of:

- For each class of financial assets and financial liabilities;
 - The fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.
 - The valuation methods and, when a valuation technique is used, the assumptions applied in determining fair values.
- For items measured based on significant non-market observable assumptions, an analysis of sensitivity of the fair values to the underlying assumptions and their income statement impact.
- For items designated at fair value through profits or losses (FVTPL), the changes in the fair value attributable to credit risk.
- The accounting policies underlying the above disclosures.

We have also considered the following SEC guidance:

- The speech by the SEC in December 2007,⁸ in particular its discussion in respect of critical accounting estimates and fair value determination, in which it requested additional disclosures on fair values measured using unobservable inputs as well as any significant changes in methodologies and assumptions;
- Financial Reporting Release 60 (FRR 60), *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, which requires explanation in management's discussion and analysis (MD&A) of the effects of the critical accounting policies applied, the judgements made in their application, and the likelihood of materially different reported results if alternative assumptions or conditions were to prevail.

8. The SEC, 'Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments' – December 2007.

While we recognise that 10 of the surveyed banks are not SEC registrants, we believe that the SEC guidance provides a useful framework against which the overall transparency of the surveyed banks' disclosures can be reviewed.

Disclosure was not reviewed for compliance with the relevant US financial reporting standards on fair value measurement and disclosure (such as SFAS 157). This standard, discussed below, requires US banks to provide more detailed disclosures and has impacted US disclosure best practices. To the extent that an IFRS reporting bank has provided disclosures in this format, following developments in US industry best practices, this has been noted.

1.3 What we saw in our last survey

At the time of our previous survey we found that the nature and extent of disclosures relating to fair value varied widely across the banks surveyed. Many banks experienced implementation issues in developing reliable IFRS-compliant models and data to calculate fair values, complying with the rules on deferral of Day 1 profits, and determining when to designate financial instruments at FVTPL.

Since our previous survey, new guidance on fair value disclosures has been issued:

- IFRS 7 became effective on 1 January 2007. This is an overall standard on disclosures with specific requirements on fair value. Though many of these were not new to IFRS, the standard's introduction resulted in banks revisiting their disclosure frameworks. Only two of the surveyed banks had early-adopted the standard at the time of our previous survey.
- SFAS 157 was introduced by the FASB with incremental, prescriptive fair value disclosure requirements. This has impacted market expectation of fair value information disclosed overall and therefore resulted in further pressure on IFRS reporters. Our current survey includes four SEC registrants who report under US GAAP (US GAAP reporters), all of whom have early adopted the standard.
- In addition, current market conditions have prompted active debate on fair value reporting, with investors and regulators demanding more transparent fair value disclosure. Banks have accommodated these demands to a varying extent.

1.4 Disclosure of methodologies to measure fair value

Robust discussion of valuation methodologies and assumptions is critical to providing the user with a clear understanding of how fair value is used. The majority of the surveyed banks provided expanded disclosures in respect of their valuation methodologies, mainly through more specific information on valuation techniques by product type and discussion of inputs used. Additional detail focused on products valued using significant unobservable parameters.

These disclosures could be further enhanced across the group by providing more specific information for all key product groups and linking discussion of valuation techniques to the underlying inputs. An example of this is set out in Extract 1 overleaf.

Extract 1: Disclosure of methodologies to measure fair value – RBS.

Commercial mortgages – senior and mezzanine commercial mortgages are loans secured on commercial land and buildings that were originated or acquired by the Group for securitisation. Senior commercial mortgages carry a variable interest rate and mezzanine or more junior commercial mortgages may carry a fixed or variable interest rate. Factors affecting the value of these loans may include, but are not limited to, loan type, underlying property type and geographical location, loan interest rate, loan to value ratios, debt service coverage ratios, prepayment rates, cumulative loan loss information, yields, investor demand, market volatility since the last securitisation and credit enhancement.

Where observable market prices for a particular loan are not available, the fair value will typically be determined with reference to observable market transactions in other loans or credit related products, including debt securities and credit derivatives. Assumptions are made about the relationship between the loan and the available benchmark data. Using reasonably possible alternative assumptions for credit spreads (taking into account all other applicable factors) would reduce the fair value by up to £52 million or increase the fair value by up to £49 million.

Source: RBS *Annual Report and Accounts 2007*.

Disclosure of the impact of current market conditions on methodologies used to measure fair value

The current market turmoil has resulted in increased credit risk and reduced liquidity, which has required banks to relook at the appropriateness of valuation methodologies and underlying assumptions. Lack of liquidity in the absence of adequate trading activity has made price discovery more difficult for certain financial instruments, requiring the use of a broader range of valuation techniques. Despite such significant implications of the changes in market conditions, banks provided limited disclosure as to whether and how their use of valuation techniques and underlying assumptions has changed. Further, discussion of judgements involved in the related decision-making was limited.

Impact of increased credit risk

The majority of the banks surveyed discussed how credit risk is incorporated into the valuation processes. However, such discussion was largely a repetition of the relevant accounting standard rather than an explanation of the impact of the current market turmoil on the reconsideration of valuation processes and assumptions. Therefore, consistency of approach was difficult to compare. Nine banks disclosed that they recognised gains due to the widening of their own credit spreads, and quantified such amounts. However, their disclosures did not provide detail of approaches to calculating these amounts.

Quantification by most banks was provided on changes in the proportion of fair value attributable to changes in credit risk for loans and receivables and financial liabilities designated at FVTPL, as required under IFRS 7.

Interpretation of financial reporting requirements for the incorporation of credit risk into valuation at a more detailed and prescriptive level, in particular for liabilities, is a relatively new area of focus. This is primarily due to the valuation of credit risk becoming more significant as a result of the recent credit crunch. Standard-setters, in conjunction with the financial services industry, have been debating the challenges of applying these requirements and are discussing the need for more definitive guidance. Recognising the challenges of this process and potential inconsistencies across the industry, more comprehensive disclosures on approaches used to determine such measurements would provide market participants with a better understanding of how the valuation of credit risk has been addressed.

An example of more transparent disclosures in this regard is set out in Extract 2.

Extract 2: Illustration of disclosure of changes in fair value attributable to changes in credit risk – JPMorgan Chase.

Note 4 - Fair Value measurements

- Credit valuation adjustments (“CVA”) are necessary when the market price (or parameter) is not indicative of the credit quality of the counterparty. As few classes of derivative contracts are listed using internally developed models that use as their basis observable market parameters. Market practice is to quote parameters equivalent to an “AA” credit rating; thus, all counterparties are assumed to have the same credit quality. Therefore, an adjustment is necessary to reflect the credit quality of each derivative counterparty to arrive at fair value.
- Debit valuation adjustments (“DVA”) are necessary to reflect the credit quality of the Firm in the valuation of liabilities measured at fair value. This adjustment was incorporated into the Firm’s valuations commencing January 1 2007, in accordance with SFAS 157. The methodology to determine the adjustment is consistent with CVA and incorporates JPMorgan Chase’s credit spread as observed through the credit default swap market.

Determination of instrument-specific credit risk for items for which a fair value election was made

The following describes how the gains and losses included in earnings during 2007 that were attributable to changes in instrument-specific credit risk were determined:

- Loans: for floating-rate instruments, changes in value are all attributed to instrument-specific credit risk. For fixed-rate instruments, an allocation of the changes in value for the period is made between those changes in value that are interest rate-related and changes in value that are credit-related. Allocations are generally based upon an analysis of borrower-specific credit spread and recovery information, where available, or benchmarking to similar entities or industries.
- Long term debt: changes in value attributable to instrument-specific credit risk were derived principally from observable changes in the Firm’s credit spread. The gain for 2007, was attributable to the widening of the Firm’s credit spread.
- Resale and repurchase agreements: generally, with a resale or repurchase agreement, there is a requirement that collateral be maintained with a market value equal to or in excess of the principal amount loaned. As a result, there would be no adjustment or an immaterial adjustment for instrument-specific credit related to these agreements.

Source: JPMorgan Chase *Annual Report 2007*.

Impact of reduced liquidity

As discussed above, reduced market liquidity may affect the valuation techniques and underlying inputs used, given reduced price availability and difficulty in demonstrating observability of inputs. IAS 39 *Financial Instruments: Recognition and Measurement* explains when a financial instrument is regarded as quoted in an ‘active market’.⁹ The Center for Audit Quality¹⁰ and the Global Public Policy Committee¹¹ have also issued further guidance to clarify what constitutes an ‘active market’, particularly in current market conditions.

9. IAS 39 paragraph AG71: ‘A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arms length basis.’

10. The Center for Audit Quality, *Measurement of Fair Value in Illiquid (or Less Liquid) Markets* – 03.10.2007.

11. The Global Public Policy Committee, *Determining Fair Value of Financial Instruments under IFRS in Current Market Conditions* – 13.12.2007.

Despite such efforts to achieve consistency in the application of these terms, variation in views on interpretation continues. Few of the surveyed banks provided information on how they have interpreted the definition of active market, thereby limiting comparability.

In certain instances, limited disclosures were provided on specific products impacted by reduced liquidity, together with the associated change in valuation techniques; however, the impact of reduced liquidity on fair values was not quantified.

Summary

The usefulness of disclosures on valuation methodologies would be improved if more detailed disclosures on methodology and underlying assumptions by product were provided. Furthermore, a clear explanation of how and why valuation methodologies and assumptions have changed in response to changes in market conditions would add value.

Acknowledging such issues amidst the current liquidity crisis, the FSF's report¹² requested the IASB to enhance its guidance on valuing financial instruments when markets are inactive. The IASB has established an expert advisory panel to assist in reviewing best practices and in proposing revised practice guidance on valuation and related disclosures when markets are no longer active.¹³

1.5 Disclosure of fair values by valuation method and impact of unobservable inputs

Disclosure of the subjectivity of certain management estimates is important to provide insight on the application of judgement and its impact on the financial statements. Acknowledging this, IFRS 7 requires disclosure of fair value amounts by valuation method to distinguish between those estimated with reference to price quotations in active markets and those using valuation techniques. Furthermore, where valuation techniques are used, additional disclosures on potential income statement impacts are required for those valuations based on unobservable data.

The standard is not prescriptive on the format and level of the disclosure and, as a result, there is significant variation across the surveyed banks.

Qualitative disclosure on classification

The majority of banks included a generic discussion of the basis for determining the classification of fair values according to valuation method, and observability of underlying inputs. These were consistent with the requirements of IFRS 7 (this classification is generally referred to as the 'fair value hierarchy' in line with the terminology used in SFAS 157) and the definition of 'observable' data provided by IAS 39. In addition, certain banks provided more detailed disclosures of the types of financial instruments presented as 'valuation techniques using non-market observable (i.e. 'unobservable') inputs'.

12. The FSF, *Enhancing Market and Institutional Resilience* issued to the G7 Ministers and Central Bank governors – 07.04.2008.

13. *The IASB Update* – June 2008.

Given current market conditions, there is great interest in understanding the movements across this ‘fair value hierarchy’ as this provides insight to changes in valuation methods used and observability of inputs from period to period. This was echoed by the SEC in its public speech delivered in December 2007, in which it stressed the importance of disclosing the drivers of such movements and, to the extent material, the nature of changes to the observability of underlying inputs.

Eight of the surveyed banks provided disclosures in this regard at varying levels of detail. Some disclosures described the increase in use of unobservable inputs by financial instrument class, noting the types of financial instruments driving the migration to this lower classification of the hierarchy and the reasons for reduced observability. One example of such disclosure is included in Extract 3.

Extract 3: Illustration of disclosure in respect of financial instruments with fair value derived from valuation techniques containing significant unobservable parameters – Deutsche Bank.

POSITIVE AND NEGATIVE MARKET VALUES FROM DERIVATIVE INSTRUMENTS: Derivatives categorized in this level of the fair value hierarchy are more complex with respect to either the model or nature of the underlying, and their valuation techniques include the use of one or more significant unobservable parameters. The unobservable parameters include certain credit, equity and foreign exchange correlations, certain longer-term volatilities and certain prepayment rates. In addition, unobservable parameters may include certain credit spreads and other transaction specific parameters.

The following derivatives are included within this level of the hierarchy: customized CDO derivatives in which the underlying reference pool is not closely comparable to regularly market traded indices, all CDO squared derivatives, certain options where the volatility is unobservable, certain basket options in which the correlation between the referenced underlying assets are unobservable, longer-term interest rate option derivatives and multi-currency foreign exchange derivatives and certain credit default swaps for which the credit spread is not observable.

In 2007, the main increase in derivatives categorized in this level of the hierarchy related to certain credit default swaps on asset-backed securities for which the credit spread became unobservable due to reduced liquidity in the period. Otherwise the nature of unobservable parameters in derivative valuations remained broadly the same with liquidity being maintained in the majority of markets.

Source: Deutsche Bank *Annual Review 2007*.

Quantitative disclosure on classification

The majority of the banks surveyed provided a level of quantitative disclosure for financial instruments classified across the ‘fair value hierarchy’ of valuation methods, according to the observability of underlying inputs. A number of banks provided this information at the balance sheet line item level of detail, and certain banks provided further detail by product type. Extract 4 overleaf is an example of disclosure of such categories within the fair value hierarchy.

Extract 4: Illustration of quantitative disclosure by valuation method – UBS.

Determination of fair values from quoted market prices or valuation techniques								
	31.12.07				31.12.06			
	Quoted market price	Valuation technique – market observable inputs	Valuation technique – non-market observable inputs	Total	Quoted market price	Valuation technique – market observable inputs	Valuation technique – non-market observable inputs	Total
CHF billion								
Trading portfolio assets	249.3	323.4	37.3	610.0	215.1	411.8	0.1	627.0
Trading portfolio assets pledged as collateral	85.3	55.8	23.2	164.3	243.5	8.0	0.0	251.5
Positive replacement values	6.8	407.4	14.0	428.2	31.3	250.2	11.5	293.0
Financial assets designated at fair value	1.8	10.0	0.0	11.8	0.0	5.1	0.8	5.9
Financial investments available-for-sale	1.2	2.4	1.4	5.0	2.5	4.6	1.8	8.9
Total assets	344.4	799.0	75.9	1,219.3	492.4	679.7	14.2	1,186.3
Trading portfolio liabilities	119.9	44.9	0.0	164.8	169.9	34.9	0.0	204.8
Negative replacement values	6.6	420.1	16.8	443.5	32.7	255.2	9.2	297.1
Financial liabilities designated at fair value	0.0	149.5	42.4	191.9	0.0	113.0	32.7	145.7
Total liabilities	126.5	614.5	59.2	800.2	202.6	403.1	41.9	647.6

Source: UBS Annual Report 2007.

The quantitative analysis provides useful information on the proportion of financial assets and liabilities measured with valuation techniques using significant unobservable inputs, compared to the total portfolio of instruments carried at fair value. Such proportions are set out in figure 2, based on the available information in respect both of total financial assets and liabilities, and of financial assets and liabilities by class:

Figure 1: Financial assets and liabilities classified by valuation method – in total.

	Bank of America	BBVA	BNP Paribas	Citi	Credit Suisse	Danske Bank	Deutsche Bank	HSBC	ING	JPMorgan Chase	RBS	Société Générale	UBS
Financial assets													
Quoted market price	7%	74%	72%	17%	24%	44%	17%	34%	75%	21%	18%	51%	28%
Valuation technique using observable market data	89%	25%	28%	73%	68%	56%	77%	63%	25%	74%	78%	47%	66%
Valuation technique using unobservable data	4%	1%	0%	10%	8%	0%	6%	3%	1%	5%	4%	2%	6%
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Financial liabilities													
Quoted market price	11%	12%	61%	8%	16%	59%	13%	32%	55%	9%	11%	9%	16%
Valuation technique using observable market data	87%	88%	38%	86%	78%	41%	85%	66%	45%	87%	86%	79%	77%
Valuation technique using unobservable data	2%	0%	1%	6%	6%	0%	2%	2%	0%	4%	3%	12%	7%
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: PricewaterhouseCoopers.

Figure 2: Financial assets and liabilities classified by valuation method – by class.

	Bank of America			BBVA			BNP Paribas			Citi			Credit Suisse			Danske Bank			Deutsche Bank		
	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III
Financial assets at fair value																					
Trading assets	27%	71%	2%	72%	28%	0%	71%	29%	0%	33%	51%	16%	29%	64%	7%	67%	33%	0%	37%	52%	11%
Derivatives	0%	98%	2%	37%	63%	0%	-	-	-	2%	91%	7%	-	-	-	-	-	-	4%	93%	3%
Financial assets designated at FVTPL	41%	38%	21%	96%	4%	0%	88%	12%	0%	0%	99%	1%	9%	81%	10%	27%	73%	0%	4%	94%	2%
Available-for-sale financial assets	1%	96%	3%	77%	22%	1%	-	-	-	31%	61%	8%	94%	6%	0%	-	-	-	32%	62%	6%
Other financial assets at fair value	0%	0%	100%	-	-	-	-	-	-	0%	0%	100%	0%	0%	100%	-	-	-	-	-	-
Financial liabilities at fair value																					
Trading liabilities	74%	26%	0%	8%	92%	0%	67%	32%	1%	88%	11%	1%	20%	76%	4%	3%	97%	0%	94%	5%	1%
Derivatives	0%	98%	2%	28%	72%	0%	-	-	-	2%	91%	7%	-	-	-	-	-	-	4%	93%	3%
Financial liabilities designated at FVTPL	0%	75%	25%	100%	0%	0%	1%	99%	0%	0%	94%	6%	8%	82%	10%	91%	9%	0%	1%	97%	2%
Other financial liabilities at fair value	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

	HSBC			ING			JPMorgan Chase			RBS			Société Générale			UBS		
	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III
Financial assets at fair value																		
Trading assets	47%	50%	3%	64%	36%	0%	49%	45%	6%	-	-	-	61%	38%	1%	43%	49%	8%
Derivatives	4%	94%	2%	91%	9%	0%	2%	96%	2%	1%	98%	1%	3%	94%	3%	2%	95%	3%
Financial assets designated at FVTPL	69%	30%	1%	92%	6%	2%	22%	42%	36%	28%	66%	6%	82%	16%	2%	15%	85%	0%
Available-for-sale financial assets	28%	69%	3%	74%	25%	1%	84%	16%	0%	37%	61%	2%	83%	12%	5%	24%	48%	28%
Other financial assets at fair value	-	-	-	-	-	-	0%	0%	100%	-	-	-	-	-	-	-	-	-
Financial liabilities at fair value																		
Trading liabilities	45%	53%	2%	50%	50%	0%	82%	18%	1%	-	-	-	11%	72%	17%	73%	27%	0%
Derivatives	5%	93%	2%	90%	9%	1%	2%	96%	2%	1%	98%	1%	8%	84%	8%	1%	95%	4%
Financial liabilities designated at FVTPL	42%	58%	0%	71%	29%	0%	0%	75%	25%	25%	71%	4%	2%	88%	10%	0%	78%	22%
Other financial liabilities at fair value	-	-	-	-	-	-	0%	97%	3%	-	-	-	-	-	-	-	-	-

Source: PricewaterhouseCoopers

- Category I: Quoted market price
- Category II: Valuation technique using observable data
- Category III: Valuation technique using unobservable data

Categories I, II and III are not necessarily directly comparable to the 'fair value hierarchy' levels 1, 2 and 3 as defined in SFAS 157 under which disclosures by the US banks are provided. Certain assumptions have been made to aggregate into standardised product types. In addition, derivatives netting is not consistent across the US bank peer group (balances in respect of Citi, Bank of America and Credit Suisse are presented on a gross basis).

From the above tables, we can see that the proportion of financial assets and financial liabilities measured with valuation techniques using significant unobservable inputs varied widely across the group. This may have been driven by the following:

- Differences in the range of products measured at fair value;
- Differences in the nature of portfolios (due to portfolio complexity as well as geographical diversity);
- Variances in interpretation and application of certain terms such as ‘observability’, ‘active market’ and ‘significant’ inputs;
- Differences in accessibility to various markets for a particular product;
- Differences in valuation process and different levels of interaction with third party valuation sources, such as pricing services and brokers, to prove price observability.

These new quantitative disclosures provide useful insight into the dependence of fair values on non-quoted market data and unobservable data. However, as the factors and assumptions above were not explicitly discussed, comparability of these disclosures across the group was reduced, which limited the insight and value such disclosure could provide.

Disclosure of fair value sensitivity and impact on profit or loss

The quantitative disclosure described above provides users of the financial statements with an understanding of the extent to which fair value measurement is based on unobservable inputs. For fair values based on unobservable inputs, IFRS 7 requires further disclosures of the sensitivity of such fair value amounts and the impact on profit or loss for the period.

The SEC supported this view in its recent comment letter,¹⁴ highlighting the need to provide disclosures on how sensitive fair value estimates are to their underlying significant inputs. To the extent a range of values is provided, the SEC requested a discussion on why management believe the range is appropriate, identifying the key drivers of variability, and how management developed the inputs used in determining the range.

Despite the focus of regulators and the market on the quality of fair value, particularly given the current market turmoil, it was noted that eight of the surveyed banks did not provide a sensitivity analysis as required by IFRS 7. Where a sensitivity analysis was provided, detail and format varied widely across the banks. Disclosure was often provided at the level of total financial instruments measured at fair value using unobservable parameters, rather than by class of such instruments, which would have been more meaningful. Few banks discussed their approach to preparing this analysis (i.e. sensitivity parameters and calculation method), therefore reducing the value of the disclosure further and making any comparison across the group difficult.

The following example reflects a sensitivity analysis disclosure that was provided at a level of detail consistent with the fair value hierarchy classification. This provides useful insight on how sensitive the fair value measure for each class of financial instruments is to its underlying assumptions.

14. ‘Sample Letter Sent to Public Companies on MD&A Disclosures Regarding the Application of SFAS 157’ released in late March 2008.

Extract 5: Illustration of sensitivity analysis disclosure – HSBC.

Effect of changes in significant non-observable assumptions to reasonably possible alternatives				
As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions.				
	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes US\$m	Unfavourable changes US\$m	Favourable changes US\$m	Unfavourable changes US\$m
At 31 December 2007				
Derivatives/trading assets/trading liabilities ¹	602	(415)		
Financial assets/liabilities designated at fair value	30	(30)		
Financial investments: available-for-sale			529	(591)
At 31 December 2006				
Derivatives/trading assets/trading liabilities	69	(72)		
Financial assets/liabilities designated at fair value	16	(16)		
Financial investments: available-for-sale			165	(165)
<p><i>1. Derivatives trading assets and trading liabilities are presented as one category to reflect the manner in which these financial instruments are risk-managed.</i></p> <p>The increase in the effect of changes in significant non-observable inputs in relation to derivatives/trading assets/trading liabilities from 31 December 2006 to 31 December 2007 primarily reflects certain mortgage loans acquired for the purpose of securitisation, and certain US mortgage-backed securities, that were valued using observable inputs at 31 December 2006 which subsequently became non-observable in the second half of 2007, following the deterioration in market conditions. To a lesser degree, the increase also reflects increased uncertainty in determining the fair value of credit derivative transactions executed against certain monoline insurers, and a general increase in structured derivative business.</p>				
Source: HSBC 2007 Annual Report and Accounts.				

Additionally, the majority of banks disclosed the impact on profit or loss of changes in fair values based on unobservable inputs. However, other than the US banks that are required to disclose a more detailed analysis of income statement impacts under SFAS 157, this was only provided at a high level with limited discussion of approach.

Summary

Additional quantitative information, where provided, has been useful in better understanding the use of fair value, but could be explained better and provided more consistently across the group.

Presenting quantitative disclosure of fair values by valuation method, at least at the balance sheet line item level, would help users understand the dependence of valuation on observable and unobservable market data. Transparency of disclosure would be further improved if banks included a description of how key terms such as ‘observability’ had been interpreted and a description of the nature of the portfolios within each valuation method classification or fair value hierarchy level.

US banks provided quantitative disclosure and discussion of the movements across fair value hierarchy levels as required by SFAS 157, and a greater explanation of valuation methods for those transactions dependent on unobservable inputs. This provides valuable insight and would further assist users in understanding the impact of valuation assumptions, if applied more widely by IFRS reporters for all transactions using unobservable inputs.

Presentation of the income statement impact of fair values using significant unobservable data was generally limited and varied. This was probably due to challenges in interpreting guidance and gathering the required information and has resulted in lack of disclosure in certain instances. Where provided, disclosures are generally kept at a high level and could be enhanced by providing the analysis in more detail, for example at the balance sheet line item level, and providing an explanation of the calculation approach and assumptions used.

Again, the income statement impact analysis required by SFAS 157, as disclosed by the US banks, provides useful insight to overall changes in the fair value of these instruments by instrument type, and could add value to the disclosures of IFRS reporters.

1.6 Disclosure on application of the FVO

The debate on the reporting of fair values in the context of the recent market turmoil has led to greater focus on the use of the FVO and the rationale and judgements underpinning this.

IFRS 7 requires disclosures that enable the users of financial statements to understand the basis and impact of such an election.¹⁵ The disclosures required include:

- The carrying amount of financial instruments designated at FVTPL, as well as the impact of such financial instruments on the income statement during the period;
- The nature of financial instruments designated at FVTPL;
- The rationale for so designating those financial instruments, including how the criteria (as described in IAS 39) have been met.

We found that all the surveyed banks disclosed which financial instruments they had elected to carry at fair value, but only provided a high-level explanation of the rationale underlying this and the judgements used in determining fair value.

Scope of application of the FVO

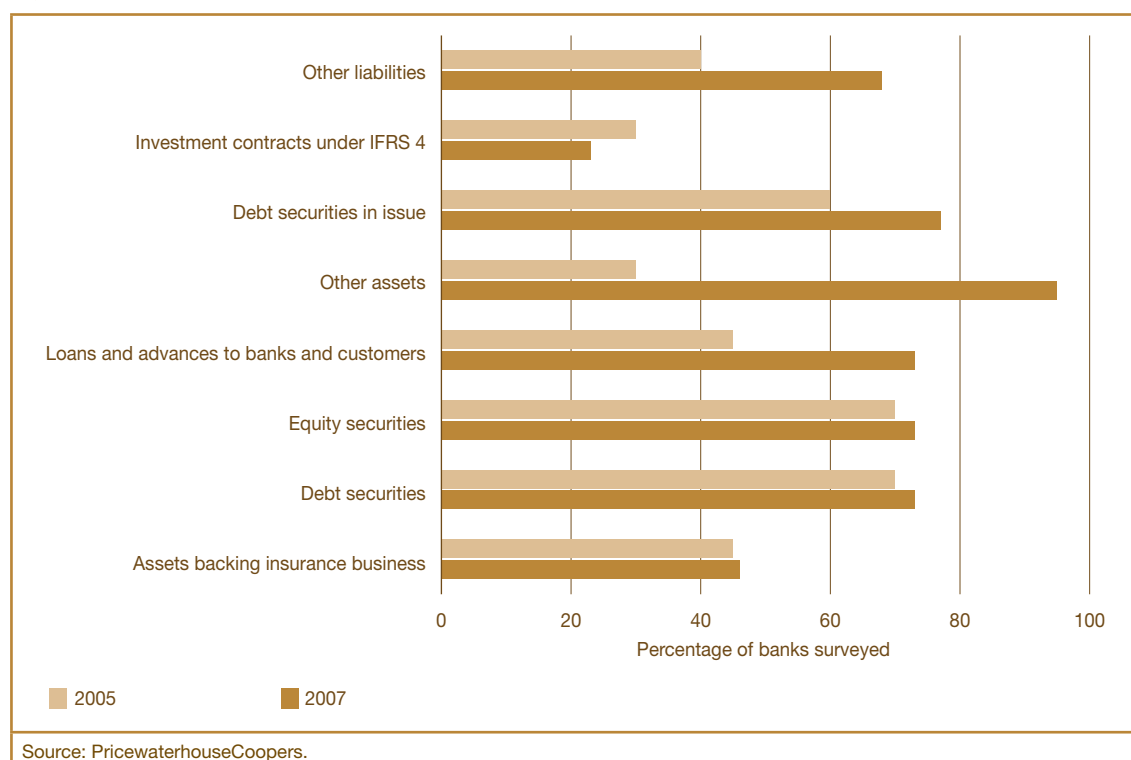
The FVO continues to be widely used across various financial instrument types, with a greater number of banks using the FVO for certain financial instruments, including loans, repos, guarantees and issued debt, compared to our previous survey of 2005 annual reports. Banks continue to use the FVO only for targeted components of financial instrument portfolios: few banks use the FVO comprehensively across the balance sheet. Given the increased use of the FVO, and the fact that instruments for which the FVO is elected may be more challenging to value, e.g. loans and issued debt, disclosure is helpful to understand management's judgement and rationale in doing so. In comparison with our previous survey, disclosure in respect of the FVO appears to be more granular, with more classes of financial instruments designated at FVTPL.

We did not observe any disclosures commenting on ceasing to use the FVO for certain transactions or products going forward as a result of the recent market turmoil.

15. Note that the disclosure requirements of SFAS 159 (as relevant to the US GAAP reporters included in our survey) are similar to IFRS 7. In addition, SFAS 159 requires disclosure of the reasons for electing the FVO for selected items within a class of financial instruments.

The types of instrument to which the FVO was applied are summarised in Figure 3:

Figure 3: Application of FVO by instrument type.



Basis for application of the FVO

We found that the basis for electing the FVO was often not disclosed by financial instrument type. A number of banks included the criteria provided in IAS 39 in their accounting policies, but often did not link these to specific financial instruments for which the FVO had been elected.

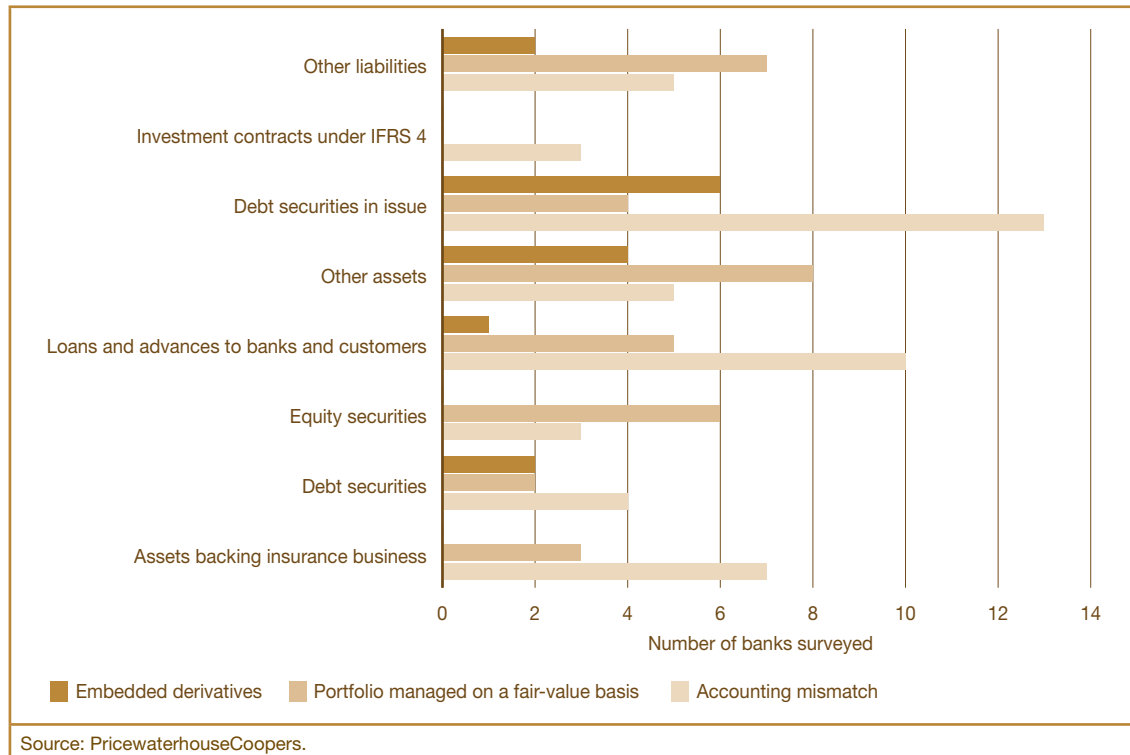
We noted several instances of the FVO being used to reduce the burden of complying with the requirements of hedge accounting, particularly in respect of certain loans held-for-sale, debt securities and structured reverse repurchase agreements.

Useful disclosure across the US GAAP reporters included explanation where the FVO was only used for certain items within a group of similar transactions. Such disclosure provided further insight to the basis for election in context of each bank's business activities and challenges in application. Reasons for such 'partial' election within a product group included:

- Investments in strategic relationships (e.g. ownership interests in certain clearance organisations);
- Lack of currently available infrastructure to fair value loans;
- Operational effort to change accounting for existing items;
- Instruments maturing in the near term.

The following figure represents the criteria under which the banks surveyed applied the FVO, by financial instrument class, where such information was available:

Figure 4: FVO criteria by instrument type.



We found that disclosures mainly served to confirm the FVO criteria provided in IAS 39 as a basis for the elections, rather than to provide meaningful discussion of management's rationale and judgements.

Summary

Discussion of management's rationale and judgement in applying the FVO by type of financial instrument would enhance understanding of the use of fair value and the underlying assumptions.

1.7 Fair value disclosures for items not carried at fair value

The challenge of assessing fair value under illiquid market conditions has placed new emphasis on understanding the determination of fair value. Such scrutiny has also been extended to disclosures for financial instruments not carried at fair value, in particular how these values reflect increased credit risk under current market conditions.

IFRS 7 requires disclosure of the fair value for all financial instruments (regardless of whether they are carried at fair value or not) with certain exceptions. It further requires disclosure to enable users of the financial statements to assess the extent of possible differences between the carrying amounts of the financial instruments and their fair values. This is particularly useful currently, where fair value accounting for certain fixed income instruments could result in losses from write-downs due to market conditions but such losses may not be captured by a cost less impairment model.

All but two of the surveyed banks disclosed the fair values of all financial assets and liabilities compared to related carrying amounts and generally provided this at the balance sheet line item level. Where no quantitative disclosure was provided, banks generally stated that fair value approximated the carrying amount. In addition, the majority of surveyed banks disclosed information on valuation techniques used at varying levels of detail.

Few banks, however, commented on the nature of the differences between the fair values and respective carrying amounts.

An example of useful disclosure explaining the linkage between the carrying amount and the fair value of loans and advances impacted by the current market turmoil is included in Extract 6.

Extract 6: Disclosure on fair value of financial instruments not carried at fair value – HSBC.

Fair value of financial instruments not carried at fair value

The fair values of financial instruments that are not recognised at fair value on the balance sheet are calculated as described below:

The calculation of fair value incorporates HSBC's estimate of the amount at which financial assets could be exchanged, or financial liabilities settled, between knowledgeable, willing parties in arm's length transaction. It does not reflect the economic benefits and costs that HSBC expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available, so comparisons of fair values between entities may not be meaningful and users are advised to exercise caution when using this data.

In recent months, the unstable market conditions in the US mortgage lending industry have resulted in a significant reduction in the secondary market demand for US consumer lending assets. Uncertainty over the extent and timing of future credit losses, together with an absence of liquidity for nonprime asset-backed securities, were reflected in a lack of bid prices other than distressed levels at 31 December 2007. It is not possible to distinguish from these indicative market prices the relative discount that reflects cash-flow impairment due to expected losses to maturity, from the discount that the market is demanding for holding an illiquid asset. Under IFRSs, HSBC recognises loan impairment based on losses incurred up to the balance sheet date: no recognition is given to losses that are expected to arise in the future, but where the loss event has not yet occurred. Neither is the asset written down to reflect its illiquidity as the intention is to fund the asset until earlier of its prepayment, charge-off or repayment on maturity. Market fair values reflect not only incurred loss, but also loss expected through the life of the asset, as well as a discount for illiquidity and a credit spread that reflects the market's current risk preference rather than the credit spread that existed in the market at the time the loan was underwritten.

The estimated fair values at 31 December 2007 of loans and advances to customers in North America reflects the combined effect of these conditions. This results in fair values that are substantially lower than the carrying value of customer loans held and lower than would otherwise be reported under more normal market conditions. Accordingly, the fair values reported do not reflect HSBC's estimate of the underlying long-term value of the assets.

Source: HSBC 2007 Annual Report and Accounts.

Summary

Increased transparency in this area would enable financial statement users to better understand the value of these assets and liabilities. Disclosure could be enhanced by providing more detail on the valuation approach and assumptions used for these disclosures and discussing the nature of differences between the fair values and carrying amounts for these financial instruments.

1.8 Disclosure of deferred Day 1 profits and losses

IFRS requires the deferral of Day 1 profits and losses (Day 1 P&L) on those transactions valued using significant unobservable inputs. IFRS 7 introduced the requirement to disclose a reconciliation of deferred amounts at the beginning and end of the reporting period. This provides useful insight to the significance of such amounts, a key area of judgement, and their impact to the income statement, in particular given the variance in the size of these reserves across different institutions.

All but six of the IFRS reporting banks disclosed that Day 1 P&L are deferred when financial instruments are valued at inception on the basis of one or more significant unobservable inputs. One bank disclosed that such treatment is also applied where the valuation models used are not recognised by the market. (Note that this observation does not include the US GAAP reporters, as SFAS 157 eliminated the previous requirement for deferral of Day 1 P&L).

Reconciliation of deferred Day 1 P&L

Given that movement analysis of deferred Day 1 P&L became a requirement on adoption of IFRS 7, the format and granularity of disclosures was varied. Evolution of disclosure in this area is expected going forward.

An example of a transparent and useful analysis is included in Extract 7.

Extract 7: Disclosure on Day 1 P&L reconciliation – Deutsche Bank.

In € m.	2007	2006
Balance, beginning of year	473	503
New trades during the period	426	271
Amortization	(132)	(40)
Matured trades	(53)	(94)
Subsequent move to observability	(186)	(168)
Exchange rate changes	(7)	1
Balance, end of year	521	473

Source: Deutsche Bank *Annual Review 2007*.

Summary

Day 1 P&L reserves relate to those transactions which are more dependent on unobservable inputs and are therefore a key area of judgement in determining fair value. Analysis of Day 1 P&L reserves movements introduced this year has provided useful transparency on the drivers of related impacts to the income statement. Disclosures could be improved if provided at a more detailed level, for example individual product group or balance sheet line item level, consistent with best practice for quantitative disclosures of fair values by valuation method, discussed in section 1.5.

1.9 Disclosure on governance and controls

Valuation is a complex process which involves applying critical judgement and discipline. Appreciating such complexity, regulators and investors are seeking to understand the effectiveness of governance and controls in response to risks associated with banks' valuation processes.

Disclosures of governance and controls to address risks associated with the valuation process are increasingly important as they provide key information on the quality of reported fair values. The FSF report supported such a view in its statement.

'Supervisors' assessments of valuation practices have stressed the importance of consistent application of independent and rigorous valuation practices across the firm.'

The FSF report further urged financial institutions to maintain sound governance and control practices associated with valuation processes, including those that deal with difficult-to-observe inputs to valuation models, model validations, price verification and related audit programs.¹⁶

We found that the majority of the surveyed banks disclosed information on the monitoring controls over their fair valuation process. Examples include:

- Valuation models, inputs and assumptions are validated independently by experts (for example, the risk management function, senior management and third party specialists).
- Complex valuation methods applied to positions that are likely to have a material impact on performance are submitted to the Audit Committee.
- Valuation models are subject to regular consistency checks and back-testing.
- Price and parameter inputs, assumptions and valuation adjustments are verified against independent sources.
- Valuations for unlisted securities are checked against a discounted cash-flow valuation based on business plans or the valuation multiples of similar companies.
- In the case of correlation-sensitive products, a comparison is made between the results obtained by the valuation model and market-corroborated inputs.
- Other valuation controls include review and analysis of daily profit or loss, validation of valuation adjustments against close-out profits or losses and Value-at-Risk (VAR) back-testing.

Summary

Banks' continued efforts in providing and improving disclosure on the governance and controls frameworks over their valuation processes provide useful transparency into the quality and reliability of reported fair values and meet the expectations of regulators and standard-setters.

16. The FSF, *Enhancing Market and Institutional Resilience* issued to the G7 Ministers and Central Bank governors – 07.04.2008.

1.10 Concluding remarks

Although it has generated controversy, we believe fair value continues to represent the best available methodology for determining and reporting the value of financial instruments. Given the importance of fair value as part of the financial reporting process, and the challenges arising from recent market conditions, robust disclosure is critical to provide the appropriate information to investors. This is echoed in the public statements recently issued by various bodies including the FSF,¹⁷ IMF¹⁸ and the CFA Institute (CFA),¹⁹ in addition to standard-setter discussions.

Banks' disclosure on fair value has increased and improved compared to the previous survey, as guidance has developed in both the US and IFRS, but application in practice is varied.

Our analysis showed the following:

- Valuation methodologies: transparency has increased, but could be further improved. Disclosures remained diverse and did not always provide a comprehensive, understandable picture of how fair value is measured, and how methodologies and assumptions have changed as a result of changes in market conditions.
- Disclosures on valuation methods and impact of unobservable inputs: disclosure was varied, given the lack of specificity in IFRS 7. Where provided, the presentation of fair values classified by method, according to the observability of underlying inputs, provided useful information in understanding the dependence of valuation on observable and unobservable market data. There was further diversity in disclosure on the sensitivity of portfolios to unobservable inputs and potential income statement impacts. Where included it was generally only provided at a very high level, which limited its usefulness. Providing these disclosures and including better explanation on the approach taken and how key terms in the guidance have been interpreted, would add value and improve users' understanding of the use of fair value.
- Application of the FVO: the nature and extent of applying the FVO was discussed at a general level. Detailed disclosures on management's rationale for this and the underlying judgements used to determine fair value were limited.
- Fair values of financial instruments not carried at fair value: disclosures were provided by most banks. Transparency was limited as banks generally did not provide insightful analysis of the underlying valuation process or the drivers of resulting differences between fair values and carrying amounts.
- Deferred Day 1 P&L: disclosures have increased as a result of IFRS 7, but there is diversity in format and disclosures could be provided at a more detailed level.
- Governance and control: banks have started to provide greater disclosures on the governance and control frameworks over valuation. This has been useful in providing an understanding of the quality of the values reported, but could be further expanded in response to ongoing regulator debate and expectations.

Achieving transparency and consistency via enhanced disclosures would be the first step towards achieving consensus on the role of fair value financial reporting. While this may not be fully accomplished for some time, we expect fair value disclosures to evolve further over the coming years as banks grow more comfortable with the new financial reporting standards and continue to endeavour to be responsive to the demands of regulators and market participants.

17. The FSF, *Enhancing Market and Institutional Resilience* issued to the G7 Ministers and Central Bank governors – 07.04.2008.

18. The IMF World Economic and Financial Surveys, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness* – April 2008.

19. The CFA Institute Centre for Financial Market Integrity – 17.03.2008.

1.11 Future developments

The IASB's long-standing project on fair value measurement is in progress, with enhancement of disclosures on fair value as one of its key objectives.²⁰ The Board issued a comment letter last year and is in the process of discussing issues with the aim of developing an exposure draft on proposed changes to guidance under IFRS, due to be issued in mid-2009.

In addition, as a result of recent market conditions and in conjunction with regulatory debate, the IASB and FASB are currently discussing the steps they are taking in response to the credit crisis. The boards agreed that they should work together to align their disclosure requirements²¹ and the IASB is giving urgency to several areas where it thinks IFRS could be improved. It has also been suggested that the lack of more prescriptive disclosures guidance is an issue for investors.

Following regulator focus and recommendations from the FSF, the IASB has established the expert advisory group to debate these issues, members of which have broad experience in valuing financial instruments in illiquid markets. As a result, the issuance of an amendment to IFRS 7 relating to disclosures on fair value measurement and off-balance sheet risks may be accelerated. Revised guidance could potentially be released as an exposure draft before the end of the year. The expert advisory group will also debate the development of further guidance on the valuation of financial instruments in illiquid markets, although the issuance process and responsibility for this has not yet been decided.

The SEC is also expressing strong views, primarily driven by the current market events. In response to the implementation of SFAS 157, the SEC has been discussing a significant level of measurement and disclosure interpretation issues with preparers, auditors and other market participants. In the letter released to public companies during March 2008, the SEC reinforced the objectives of SFAS 157 disclosures and requested specific additional disclosures to be incorporated from the first quarter reporting in 2008.²² These included:

- More detailed discussion of the assets and liabilities measured using significant unobservable inputs, specifically in terms of their magnitude, sensitivity and impacts on the financial results.
- More information on assets underlying any asset-backed securities, for example, the types of loans (subprime, Alt-A, or home equity lines of credit), including their nature, vintage and the credit ratings.
- Information on the use of relevant market indices in applying valuation techniques or models and their validation.
- Potential impacts of changes in the aggregate fair value of an entity's assets and liabilities on its liquidity and capital resources.

In summary, consideration of developments in disclosures guidance continues to be an area of focus for both US and international standard-setters' in response to market and regulator demands. We expect to see further progress during 2008 with continued pressure on banks to improve disclosures in this area.

20. 'The Board's objectives in the fair value measurement project are to: (a) establish a single source of guidance for all fair value measurements required or permitted by existing IFRSs to reduce complexity and improve consistency in its application; (b) clarify the definition of fair value and related guidance to more clearly communicate the measurement objective; and (c) enhance disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used to measure assets and liabilities and to provide them with information about the inputs used to derive those fair values.' 'The Group thinks this project should be completed by mid-2011 by limiting its objectives to the following: a) Amending existing IFRS to replace the various measurement terms used with either entry price or exit price based on the intent of the existing standard b) Defining exit price identically to Statement 157 c) Defining a comparable entry price, and providing disclosures about entry and exit price measurements.'

21. 'Standard-setters responses to the credit crisis – IASB and FASB', *IASB Update* – April 2008.

22. As FPIs are not required to file quarterly reports with the SEC, the implication of these requirements for them would be to include those additional disclosures beginning from their next interim report filing.



Structured finance

2.1 Overview

Structured finance activities and related products have been dramatically impacted by significant losses on investments and by a lack of liquidity. The current market turmoil has resulted in structured finance activities becoming a heated point of debate in the investor and regulatory communities. Regulators have voiced concern that sound disclosure is essential to achieve transparency, maintain market confidence and promote effective market discipline. In a recent report, the FSF noted that while disclosure of structured finance-related risk exposures has improved:

*A lack of adequate and consistent disclosure of risk exposures and valuations continues to have a corrosive effect on confidence.*²³

Investor pressure has also highlighted the need for institutions to ensure that disclosures of exposure and risks of complex structured products are more transparent. Investors and regulators are not alone in their concerns. Financial institutions are also voicing this sentiment. Boardroom agendas now include the topic of structured finance transparency and the media have reported that ‘transparency is now being used as a competitive weapon,’²⁴ which has added to the pressure to increase it. Deutsche Bank’s chief executive Josef Ackermann was recently quoted resonating the need for greater transparency in a speech to the London School of Economics:

*Improved transparency is decisive, including disclosure of off-balance sheet exposures, such as structured investment vehicles.*²⁵

This highlights the point that compliance with the minimum GAAP financial statement disclosures may not provide investors with information with which to evaluate results and performance; this issue is not only important to preparers, auditors and regulators, but also relevant to bank executives and their investors. The results of our survey indicate that although certain disclosures of structured finance activities have improved in response to recent market events, financial statement users may still find it difficult to fully assess the exposure and risks related to a bank’s structured finance activities.

In this survey we have defined structured finance as being a broad range of a bank’s client-led activities, including any combination of the following:

- Structured investment vehicles (SIVs);
- Collateralised debt obligations (CDOs);
- Securitisation structures such as asset-backed securities and commercial paper conduits;
- Other off-balance sheet structures including special purpose entities (SPEs);
- Structured lending;
- Syndicated loans.

23. The FSF, *Enhancing Market and Institutional Resilience* issued to the G7 Ministers and Central Bank governors – 07.04.2008.

24. ‘More holes than thou – The guessing game continues’, *The Economist* – 21.02.2008.

25. ‘Ackermann seeks greater banking transparency’, *Financial Times* – 16.01.08.

- Client credit risk management products
- Private equity and venture capital activity
- Structured leasing

2.2 Disclosure guidance

As discussed in our previous survey, there is not presently a comprehensive set of disclosure requirements under IFRS for structured finance activities. For example, the ability of a user of financial statements to identify a bank's structured finance activities is restricted, largely because of the following:

- Structured finance activity is included in general disclosure of other vanilla products (for example commercial paper and/or capital notes held in a structured investment vehicle could be included in overall loan and allowance disclosures and the inherent risks of the overall structure are not disclosed).
- Often a structured product is part of a wider transaction and separate identification or explanation in the context of the whole transaction may be missing (for example, derivatives embedded in structured finance transactions may be included in derivatives disclosures, although the nature of the overall transaction and the context in which the derivatives are used is not disclosed).

While there is not a comprehensive set of disclosure requirements under IFRS, SEC registrants are subject to certain regulatory disclosure guidance in the form of Financial Reporting Releases (FRRs), SEC speeches and other SEC communications. We recognise that 10 of the surveyed banks are not SEC registrants, but, in the absence of specific IFRS or US GAAP guidance, we believe the SEC requirements provide a useful framework to analyse the surveyed banks' disclosures.

The following were considered in analysing the structured finance disclosures of the surveyed banks:

- FRR 60 requires explanation in MD&A of the effects of the critical accounting policies applied, the judgements made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail. Additionally, IAS 1 requires a similar disclosure of significant accounting policies to be presented in the footnotes to the financial statements.
- FRR 61 *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* encourages companies to include expanded, as well as tabular, disclosure of the nature of, and accounting for, off-balance sheet arrangements.
- IFRS 7 requires disclosure of the nature and carrying amount of assets that do not qualify for derecognition and the risk and rewards of ownership to which the entity remains exposed.
- Recent SEC speeches/letters delivered to certain registrants in December 2007 requested additional disclosures on exposure to commercial paper conduits, SIVs, CDOs, or other similar entities, including categories and ratings, write-downs or downgrades, weighted average life of related assets.
- Recent media reports, as well as reports from the FSF, SSG and IMF, provide additional perspective on disclosure of structured finance activities in their papers, respectively entitled *Enhancing Market and Institutional Resilience*, *Leading Practice Disclosures for Selected Exposures* and *Global Financial Stability Report – Containing Systemic Risks and Restoring Financial Soundness*.

In addition to the above, we identified additional disclosures that may be helpful in increasing transparency under IFRS and US GAAP.

2.3 What we saw in our last survey

In our previous survey we identified diversity, both in the level and nature of structured finance activities and the extent of the related disclosures. While financial statement users value information on structured finance activities, extracting it from the financial statements was difficult, given that information was generally incorporated into other disclosures. Our overarching observation from the previous survey was that, given the extraordinary growth and complexity of structured finance activities, the financial statements did not provide enough transparency to properly assess the exposure and risks of such activities.

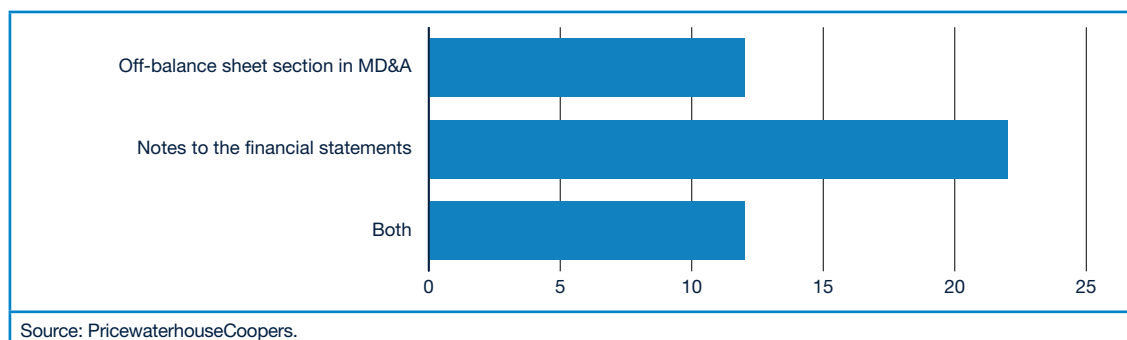
2.4 What we are seeing today

Overall, we noted enhancement of certain structured finance-related disclosures, due to the addition of new disclosures focusing on the activities and related structures most impacted by market events (SIVs, CDOs, etc.). However, this improvement varied among the surveyed banks. Disclosures surrounding those activities not directly affected by recent market dislocations remained relatively unchanged from our previous survey. In general, the disclosures around the type, extent and complexity of the structured finance activities of the surveyed banks remained diverse in both quality and readability. Certain banks provided detailed, tailored quantitative information, including on- and off-balance sheet analysis, as well as funded and committed lines; others provided only brief qualitative information on one activity or in some cases no information at all. This diversity is driven in part by a lack of comprehensive standards requiring specific disclosure and industry practice, and in part by the wide variety of structured finance activities across the surveyed banks.

Information relating to the banks' structured finance activities was provided in several locations throughout the MD&A and notes to the financial statements and/or integrated into other general disclosures (e.g. IFRS 7 disclosures). The fact that the disclosures are not found or referenced in a single location, combined with the lack of disclosure of the type of structured finance activity that banks engage in, made comparing the various disclosures difficult.

Figure 5 illustrates the inconsistency of the location of the surveyed banks' structured finance disclosures.

Figure 5: Location of disclosures for structured finance activities.



The majority of the surveyed banks disclosed their structured finance activities in either the MD&A, footnotes, or both. However, three of the surveyed banks included certain off-balance sheet activities and amounts as a separate caption on the face of the financial statements.

UBS provided a helpful key to assist the reader in identifying where certain structured finance-related disclosures were provided within the financial statements. The disclosure provided by UBS is presented in the extract below:

Extract 8: Illustration of disclosure location key surrounding off-balance sheet arrangements, risks, consolidation and fair value measurements – UBS.

Off-balance sheet arrangements, risks, consolidation and fair value measurements	Disclosure in the Annual Report
Credit guarantees, performance guarantees, undrawn irrevocable credit facilities and similar instruments	<i>Strategy, Performance and Responsibility</i> , section Off-balance sheet arrangements, and <i>Risk, Treasury and Capital Management</i> , section Liquidity and funding management
Contractual obligations	<i>Strategy, Performance and Responsibility</i> , section Off-balance sheet arrangements
Derivative financial instruments	Financial Statements, Note 23 Derivatives and Hedge Accounting
Leases	Financial Statements, Note 25 Operating Lease Commitments
Non-consolidated securitization vehicles – agency transactions	<i>Strategy, Performance and Responsibility</i> , section Off-balance sheet arrangements
Non-consolidated securitization vehicles – non-agency transactions	<i>Strategy, Performance and Responsibility</i> , section Off-balance sheet arrangements
Risk concentrations	<i>Risk, Treasury and Capital Management</i> , section Risk concentrations
Credit risk information	<i>Risk, Treasury and Capital Management</i> , section Credit risk
Market risk information	<i>Risk, Treasury and Capital Management</i> , section Market risk
Investment risk information	<i>Risk, Treasury and Capital Management</i> , section Investment positions
Liquidity risk information	<i>Risk, Treasury and Capital Management</i> , section Treasury and Capital Management, Liquidity and funding management
Consolidation	Financial Statements, section Critical accounting policies
Fair value measurements, including Level 3 sensitivity and Level 3 impact on the income statement	Financial Statements, Note 26 Fair Value of Financial Instruments

Source: UBS Annual Report 2007.

Regulatory requirements also drove the location and relative length of disclosures for certain banks. In line with SEC requirements, 12 of the surveyed banks provided disclosures of structured finance activities in a section commonly labelled as 'Off-balance sheet arrangements' within the MD&A.

The size of the 'Off-balance sheet arrangements' section of the MD&A ranged from one to 12 pages. While non-SEC registrants did not provide a separate discussion of their structured finance activities in a discrete section (e.g. 'Off-balance sheet arrangements') of the financial statements, in most cases these banks included some focused discussion of their structured finance activities in footnotes to the financial statements or in the MD&A in relation to recent market dislocations; these were titled, for example, 'Effects of the financial crisis'.

Some commonly used descriptions of structured finance activities may not be understood by the average investor. While many of the surveyed banks did not provide definitions of structured finance activities, five provided an informative and helpful glossary to their financial statements which defined/explained certain terms or acronyms. Definitions included: collateralised debt obligation-squared, credit default swap, interest-only strip, qualifying special purpose entity, securitisation, structured investment vehicle and special purpose entity.

Although the overall disclosure for structured finance activities varied significantly, certain discrete areas of structured finance-related activity, namely SPEs and securitisations, were specifically disclosed by almost all of the surveyed banks. The following sections discuss these areas.

2.4.1 SPE disclosures

Twenty of the surveyed banks disclosed the use of SPEs in their structured finance-related activities. The banks used SPEs to provide structured products to clients, for internal risk management purposes, to obtain liquidity and to achieve favourable capital treatment.

Disclosures focused on:

- Nature of the SPE activities;
- The bank's involvements in SPE activities, both qualitatively (i.e. role in the transaction) and quantitatively (i.e. risk exposures, such as maximum losses).

Banks that disclosed the nature and purpose of their SPEs commonly cited their use in the following structured finance activities:

- Securitisations;
- Structured debt issues and structured lending;
- Leasing transactions;
- Asset-backed commercial paper issues (ABCP);
- SIVs;
- CDOs;
- Asset realisation;
- Credit protection;
- Investment structures for client use.

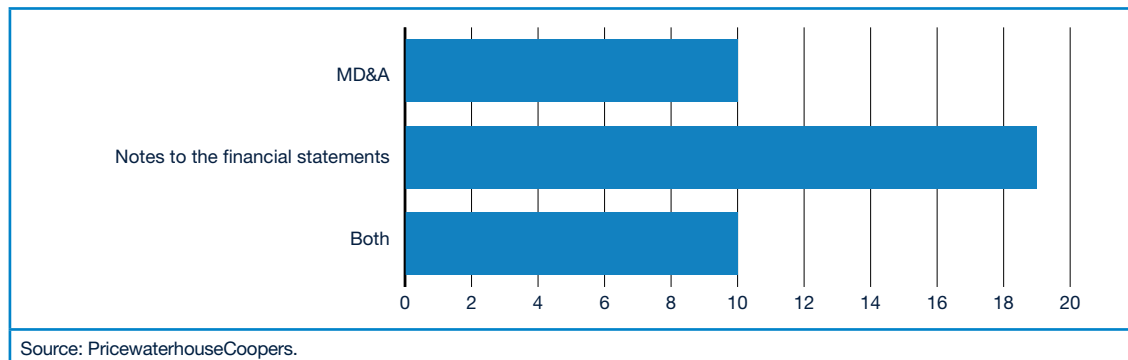
While banks provided a variety of qualitative and quantitative information related to their off-balance sheet risk exposures, quantitative disclosures by category of risk (i.e. market risk, credit risk, liquidity risk) were not provided in a consolidated format. Rather, disclosures by type of risk were disaggregated throughout the MD&A and financial statements, and were generally included within the applicable heading in the risk management or other section of the MD&A and financial statements. When such information was provided, most banks did not elaborate on how risk exposures were quantified.

Disclosure of quantitative risk exposures is valuable; it provides investors with a comprehensive understanding of the potential impact to the financial statements, should the unconsolidated entity experience losses, or should the bank be required to provide funding support to the entity in the future. This section highlights our observations of three separate areas of SPE disclosures: consolidation accounting policies, reconsideration events and disclosures surrounding recent market conditions.

SPE – Consolidation policy disclosures

The decision whether to consolidate (or not consolidate) an entity represents an important and often complex area of financial reporting. The number of banks that included consolidation as a significant and/or critical accounting policy in the financial statements is presented in the following chart:

Figure 6: Consolidation policy disclosures.



IAS 1 requires an entity to disclose the judgements management has made in the process of applying the entity’s accounting policies that have the most significant effect on the amounts recognised in the financial statements. For many of the banks surveyed, we found that the significant/critical accounting policy disclosures surrounding SPEs provided a brief repetition of the relevant consolidation standards rather than a tailored discussion of specific policies.

While IFRS consolidation principles are based upon the principles of control, when control is not apparent, the economic risk and rewards of the transaction become more significant indicators of which entity controls and thus should consolidate an SPE. Under US GAAP, the control and consolidation of an entity is evaluated using two different models: the variable interest (risk/rewards) model and the voting interest model. The extent of judgement and assumptions included in the assessments under IFRS and US GAAP are significant. Given the complexity of this area, and the judgement required, users may value additional information on the more subjective assumptions (e.g. the estimated probability and magnitude of risk/rewards) utilised by management in consolidation analyses. Recent media coverage has also highlighted

this issue and has questioned whether the economic risk and reward tests surrounding consolidation assessments should be more clearly disclosed in the financial statements, so that investors could better understand the risk that an off-balance sheet entity might be consolidated in the future.

While most of the surveyed banks did not provide detailed disclosures on assumptions made in quantitative risk and reward tests, the following extract provides a more robust example of such disclosure in relation to conduits:

Extract 9: Illustration of risk and rewards test approach – Citi.

FIN 46-R requires that the Company quantitatively analyze the expected variability of the Conduit to determine whether the Company is the primary beneficiary of the conduit. The Company performs this analysis on a quarterly basis, and has concluded that the Company is not the primary beneficiary of the conduits as defined in FIN 46-R and, therefore, does not consolidate the conduits it administers. In conducting this analysis, the Company considers three primary sources of variability in the conduit: credit risk, interest rate risk and fee variability.

The Company models the credit risk of the conduit's assets using a Credit Value at Risk (C-VaR) model. The C-VaR model considers changes in credit spreads (both within a rating class as well as due to rating upgrades and downgrades), name-specific changes in credit spreads, credit defaults and recovery rates and diversification effects of pools of financial assets. The model incorporates data from independent rating agencies as well as the Company's own proprietary information regarding spread changes, ratings transitions and losses given default. Using this credit data, a Monte Carlo simulation is performed to develop a distribution of credit risk for the portfolio of assets owned by each conduit, which is then applied on a probability-weighted basis to determine expected losses due to credit risk. In addition, the Company continuously monitors the specific credit characteristics of the conduit's assets and the current credit environment to confirm that the C-VaR model used continues to incorporate the company's best information regarding the expected credit risk of the conduit's assets.

The Company also analyzes the variability in the fees that it earns from the conduit using monthly actual historical cash flow data to determine average fee and standard deviation measures for each conduit. Because any unhedged interest rate and foreign currency risk not contractually passed on to customers is absorbed by the fees earned by the Company, the fee variability analysis incorporates those risks.

The fee variability and credit risk variability are then combined into a single distribution of the conduit's overall returns. This return distribution is updated and analyzed on at least a quarterly basis to ensure that the amount of the Subordinate Loss Notes issued to third parties is sufficient to absorb greater than 50% of the total expected variability in the conduit's returns. The expected variability absorbed by the Subordinate Loss Note investors is therefore measured to be greater than the expected variability absorbed by the Company through its liquidity arrangements and other fees earned, the surety bond providers, and the investors in commercial paper and medium-term notes. While the notional amounts of the Subordinate Loss Notes are quantitatively small compared to the size of the conduits, this is reflective of the fact that most of the substantive risks of the conduits are absorbed by the enhancements provided by the sellers and other third parties that provide transaction-level credit enhancement. Because FIN 46-R requires these risks and related enhancements to be excluded from the analysis, the remaining risks and expected variability are quantitatively small. The calculation of variability under FIN 46-R focuses primarily on *expected* variability, rather than the risks associated with extreme outcomes (for example, large levels of default) that are expected to occur very infrequently. So while the Subordinate Loss Notes are sized appropriately compared to expected losses as measured in FIN 46-R, they do not provide significant protection against extreme or unusual credit losses.

Source: Citi 2007 Annual Report on Form 10-K.

SPE – Reconsideration event disclosures

The guidance provided in both IFRS and US GAAP recognises, to differing prescriptive degrees, that changes in circumstance may occur which would require a reporting entity to re-evaluate whether it should consolidate or deconsolidate an entity (frequently termed a ‘reconsideration event’). For example, if recent market events result in changes to how an SPE is funded or to how key financial and operating decisions are made, this would be deemed a reconsideration event.

A spate of reconsideration events during the year resulted in the unexpected consolidation of several off-balance sheet entities. Some of these reconsideration events related to SIVs or ABCP conduits. In many cases, the consolidation of these entities resulted in a negative impact to the capital position of the bank. For example, a sponsoring bank might provide support to an SPE (either voluntarily due to reputational purposes or due to contractual obligations) by purchasing its commercial paper such that the bank now holds the majority of exposure to the SPE; accounting rules for consolidation would require the SPE to be consolidated onto the bank’s balance sheet. For banks subject to the Basel regulatory regime, regulatory capital requirements would require applying the requisite Basel risk weights to these new assets, with a detrimental impact on the capital position of the bank.

The following table shows some institutions affected by reconsideration events, the type of support that led to the reconsideration event, and the media headline describing the event:

Bank	Reconsideration event	Headline
HSBC	Funding support	<i>HSBC Plans US \$35bn SIV Overhaul</i> (Reuters – 27 November 2007)
Citi	Guarantee of financial support	<i>Citigroup in embarrassing move to consolidate \$49bn of its SIVs</i> (Financial Times – 14 December 2007)
Société Générale	Funding support	<i>Société Générale will bail out its only SIV</i> (Wall Street Journal – 11 December 2007)
Credit Suisse	Funding support	<i>Credit Suisse to buy Victoria SIV</i> (Euroweek – 4 January 2008)

Nine of the surveyed banks disclosed reconsideration events during the year. Of those, five disclosed that the reconsideration event resulted in consolidation of the applicable SPEs.

Reconsideration events disclosed included changes in:

- governing rules;
- contractual arrangements;
- vesting of potential rights;
- change in value or risk in SPEs’ assets;
- capital structure;
- A bank’s voluntary and involuntary disposition or acquisition of interests in a SPE.

Most of the surveyed banks did not provide detailed disclosures on policies, procedures and monitoring controls around the review of reconsideration events. Such information would provide financial statement users with information on the type of involvement that might be viewed as a reconsideration event and would allow users to have an understanding of what events might lead

to the bank recognising future gains/losses and/or consolidating/deconsolidating entities in the future. In addition, this information is relevant to investors as it provides evidence that the bank is monitoring its exposures. The following extract provides an example of disclosure on the process around evaluating reconsideration events:

Extract 10: Illustration of process around reconsideration events – Deutsche Bank.

The Group will reassess consolidation status at least at every quarterly reporting date. Therefore, any changes in structure are considered when they occur. This includes changes to any contractual arrangements the Group has, including those newly executed with the entity, and is not only limited to changes in ownership.

The Group reassesses its treatment of SPEs for consolidation when there is an overall change in the SPE's arrangements or the substance of the relationship between the Group and an SPE changes due to current market conditions or any other factors so that there are new activities between the Group and the SPE, which were not foreseen originally. Factors indicating a change in the substance of the relationship between the Group and the SPE include, but are not limited to, the following:

- changes in the Group's ownership interest in the SPE;
- changes in contractual or governance arrangements of the SPE;
- additional activities undertaken in the structure; for example, providing a liquidity facility beyond the terms established originally or entering into a transaction with an SPE that was not contemplated originally; and
- changes in the financing structure of the entity.

In addition, when the Group concludes that the SPE might require additional support to continue in business, and such support was not contemplated originally, and, if required, the Group would provide such support for reputational or other reasons, the Group will reassess the need to consolidate the SPE.

The reassessment of control over the existing SPEs does not automatically lead to consolidation or deconsolidation. In making such a reassessment the Group may need to change its assumptions with respect to loss probabilities, the likelihood of additional liquidity facilities being drawn in the future and the likelihood of future actions being taken for reputational or other purposes. All currently available information, including current market parameters and expectations (such as loss expectations on assets), which would incorporate any market changes since inception of the SPE, are used in the reassessment of consolidation conclusions.

Source: Deutsche Bank *Annual Review 2007*.

Given recent market turmoil and the number of reconsideration events that led to consolidation of SPEs, additional disclosure could be beneficial. This should focus on consolidation policies relating to the application of quantitative and qualitative assessments of risk and rewards, and monitoring controls around reconsideration events. A more robust disclosure of management’s process for evaluating SPEs for consolidation/deconsolidation might include:

- Description of the nature of the risks in the SPE;
- Description of management’s consolidation policy and how risks and rewards are evaluated and/or modelled and a description of events that may lead to the bank recognising future gains/losses and/or consolidating/deconsolidating an SPE in the future (i.e. reconsideration events).

SPE – Recent market condition disclosures

While various levels and depth of analysis were noted, all of the surveyed banks provided analysis and commentary on the dislocation in the credit markets during 2007. These events and the resulting liquidity crisis required several banks to provide funding support to SPEs or other customers and off-balance sheet entities.

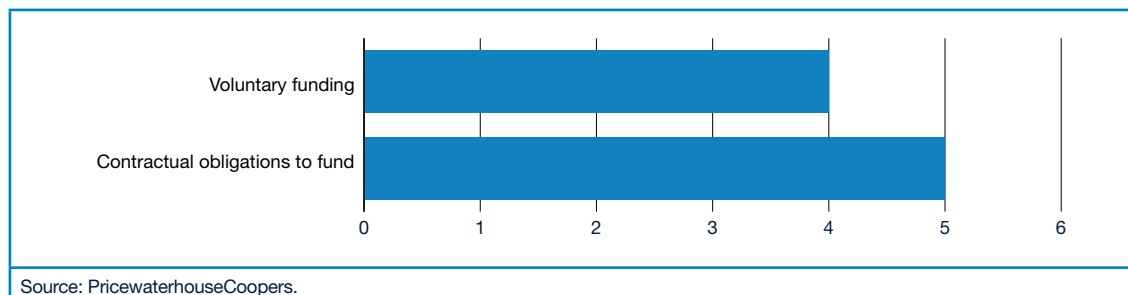
Funding support and credit enhancements

The surveyed banks provided support to off-balance sheet entities in the following forms:

- Cash, where net asset values declined below a certain threshold;
- Funding support (via issuance of letters of credit);
- Purchase of assets;
- Absorption of market losses on the sale of assets in the event of a downgrade or decline in credit quality of the assets;
- Market value support in the form of total return swaps over specific assets purchased by the entities from third parties;
- Repayment of debt issued by the entity;
- Commercial paper purchases;
- Liquidity puts.

The number of banks that provided support, either voluntarily or under existing contractual commitments, to fund an off-balance sheet entity is presented in the following figure:

Figure 7: Driver of banks’ funding activities to off-balance sheet entities.



Banks are also linked to SPEs via future funding commitments (liquidity facilities) and credit enhancements, which may require the bank to provide future financial support. Some helpful disclosures included: maximum exposure to specific structured finance activities under funding commitments (SIVs, ABCP conduits, CDOs), exposures by geography and exposures by asset type. The following extract provides an example of a disclosure outlining funding commitments and amounts drawn by structured finance activity.

Extract 11: Funding commitment disclosures by activity – HSBC.

HSBC's commitments under liquidity facilities to third party SIVs, conduits and securitisations		
	Commitments US\$bn	Drawn US\$bn
2007		
Third party SIVs	0.3	–
Third party conduits	5.3	0.4
Third party securitisations	0.5	–
	6.1	0.4
2006		
Third party SIVs	0.2	–
Third party conduits	5.4	–
Third party securitisations	0.5	–
	6.1	–

Source: HSBC 2007 Annual Report and Accounts.

Exposures to off-balance sheet entities

Eighteen of the surveyed banks disclosed quantitative exposures to commercial paper conduits, SIVs, CDOs or other similar entities; however, these disclosures varied significantly in their format and extent. The most robust disclosures provided information on entities that were and were not consolidated, including the size of the activities of the SPEs, the nature of the bank's involvement, and the bank's maximum exposure to losses, as well as information surrounding the composition of assets underlying the SPEs.

More detailed information consisted of the following: tailored discussion on the nature and risks of the activities for which the bank is exposed and quantitative tabular disclosures on the credit rating and weighted average life of the off-balance sheet entities' assets/liabilities. This information provides insight into the quality of the assets held in the structures (e.g. subprime, Alt-A, prime). It also highlights the fact that there could be significant differences between the tenor of the liabilities used to fund the off-balance sheet entity and the tenor of the assets in the off-balance sheet entity (typically referred to as liquidity risk).

Nine of the surveyed banks provided disclosures of the weighted-average life of assets and related liabilities held in the off-balance sheet entities as well as their credit ratings, to a varying extent. Some banks only provided this information for certain activities (e.g. CDOs, SIVs or ABCP conduits). We found that additional quantitative information on the type, geographic distribution, average maturity and credit rating of the collateral provided increased transparency. Six of the surveyed banks provided weighted-average life of the funding provided to the off-balance sheet entities.

The following extract is an example of a more robust disclosure that outlines the commitments and assets held by a bank's administered multi-seller conduits. The information provided includes: funding commitments, funded assets by category, liquidity provided by third parties, credit ratings of assets and the weighted-average life of those assets.

Extract 12: Illustration of off-balance sheet disclosures – JPMorgan Chase.

Summary of exposure to Firm-administered nonconsolidated multi-seller conduits

December 31 (in billions)	2007				2006			
	Unfunded commitments ^a	Funded assets	Liquidity provided by third parties	Total exposure	Unfunded commitments ^a	Funded assets	Liquidity provided by third parties	Total exposure
Asset types:								
Credit card	\$ 3.3	\$ 14.2	\$ –	\$ 17.5	\$ 3.8	\$ 10.6	\$ –	\$ 14.4
Automobile	4.5	10.2	–	14.7	4.2	8.2	–	12.4
Trade receivables	6.0	6.6	–	12.6	5.6	7.0	–	12.6
Education loans	0.8	9.2	–	10.0	0.3	0.9	–	1.2
Commercial	2.7	5.5	(0.4)	7.8	2.3	3.8	(0.5)	5.6
Residential mortgage	4.6	3.1	–	7.7	4.1	5.7	–	9.8
Capital commitments	2.0	5.1	(0.6)	6.5	0.8	2.0	(0.2)	2.6
Other	3.8	7.3	(0.6)	10.5	2.3	5.4	(0.3)	7.4
Total	\$ 27.7	\$ 61.2	\$ (1.6)	\$ 87.3	\$ 23.4	\$ 43.6	\$ (1.0)	\$ 66.0

December 31, 2007 (in billions)	Ratings profile of VIE assets ^b					Funded assets	Wt. avg. expected life (years) ^c
	Investment-grade				Noninvestment-grade		
	AAA to AAA-	AA+ to AA-	A+ to A-	BBB to BBB-	BB+ and below		
Asset types:							
Credit card	\$ 4.2	\$ 9.4	\$ 0.6	\$ –	\$ –	\$ 14.2	1.5
Automobile	1.8	6.9	1.4	–	0.1	10.2	2.3
Trade receivables	–	4.7	1.7	0.2	–	6.6	1.3
Education loans	1.0	8.1	0.1	–	–	9.2	0.5
Commercial	0.5	4.2	0.7	0.1	–	5.5	2.6
Residential mortgage	1.5	0.8	0.8	–	–	3.1	1.5
Capital commitments	–	5.1	–	–	–	5.1	3.4
Other	2.0	4.6	0.4	0.2	0.1	7.3	2.0
Total	\$ 11.0	\$ 43.8	\$ 5.7	\$ 0.5	\$ 0.2	\$ 61.2	1.8

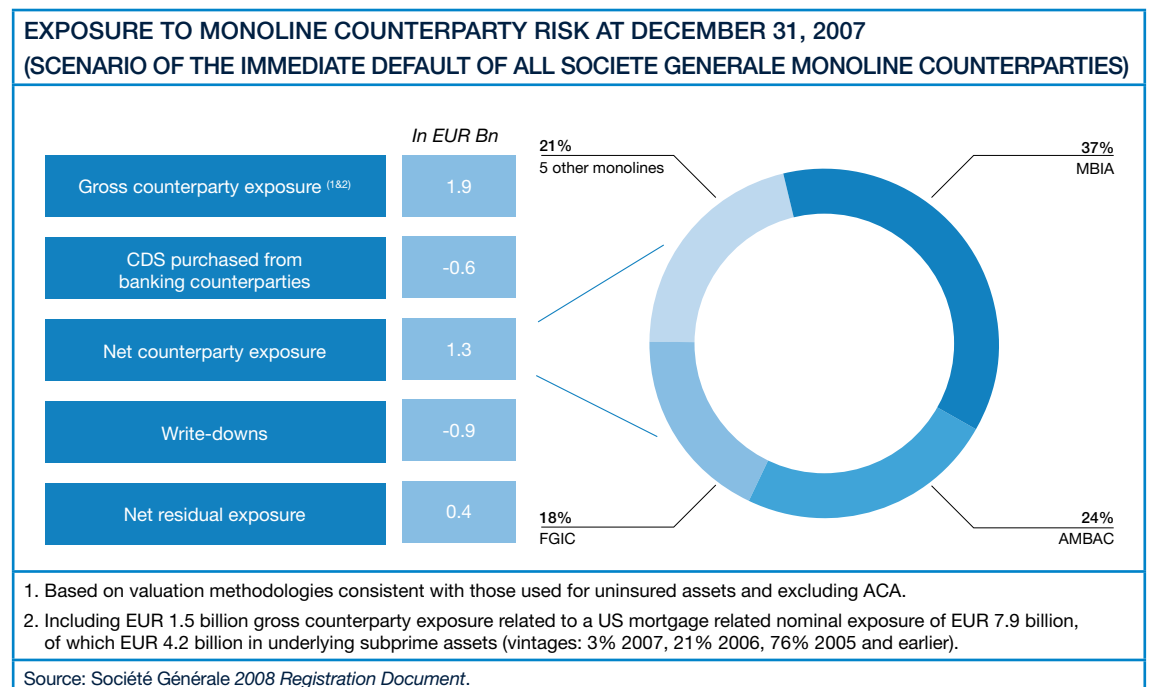
- a. Unfunded commitments held by the conduits represent asset purchase agreements between the conduits and the Firm.
b. The ratings scale is presented on an S&P equivalent basis.
c. Weighted average expected life for each asset type is based upon the remainder of each conduit transaction's committed liquidity plus the expected weighted average life of the assets should the committed liquidity expire without renewal, or the expected time to sell the underlying assets in the securitization market.

Source: JPMorgan Chase Annual Report 2007.

Some banks provided additional information on the impact of consolidating off-balance sheet entities. For example, Deutsche Bank noted that its off-balance sheet arrangements did not have a material impact on debt covenants, capital ratios, credit ratings, or dividends. Additionally, JPMorgan Chase provided a quantitative disclosure on the impact to capital, should the bank be required to consolidate all of a specific type of SPE it administers (e.g. multi-seller conduits). While many of the surveyed banks provided maximum risk exposure to credit risk for off-balance sheet entities, the majority did not provide comprehensive disclosures on the potential impact on capital ratios, debt covenants, credit ratings, collateral requirements or dividends should the bank be required to consolidate any off-balance sheet entity, or incur significant losses associated with such an entity. While current GAAP may not require it, disclosure of potential future consolidations of off-balance sheet entities would provide users with useful information to assess risk exposures. Additionally, while IFRS 7 requires disclosures of the credit quality of on-balance sheet assets, disclosure of off-balance sheet credit risk, including interests held in off-balance sheet vehicles, guarantees, facility agreements, and other off-balance sheet exposures, would be helpful.

Another area where banks have seen increased credit exposure relates to hedging activities with monoline insurers where banks have purchased credit protection to hedge exposures to structured products issued by off-balance sheet entities (e.g. CDOs). This is an area of interest to investors, particularly considering recent credit downgrades experienced by such insurers. Of the surveyed banks, 13 disclosed their exposure with the monoline insurer sector. While some banks provided total exposure to monoline insurers, the following extract shows disaggregated amounts by insurer, which may assist a reader in more fully understanding specific exposures:

Extract 13: Illustration of monoline insurer exposure – Société Générale.



2.4.2 Securitisation disclosures

Disclosure and transparency in securitisation transactions, has become a key focus as a result of recent market turmoil. According to an article by Baker and McKenzie, 'Basel II Big Bang: Full Implementation of the CRD', bodies such as the European Commission believe there is insufficient disclosure of the nature of banks' securitisation activity, as well as a great deal of uncertainty about banks' individual exposures to securitisation transactions. This sentiment has been echoed by investors and analysts as well.

Securitisation – policy disclosures

The disclosure of the surveyed banks' securitisation activity, as well as of individual exposures to securitisation transactions, was wide and varied. Of the surveyed banks, 20 disclosed securitisation activity as well as their accounting policies surrounding derecognition.

However, consistent with the SPE consolidation policies noted above, most of the banks provided only a brief repetition of the relevant derecognition standards rather than a tailored discussion of specific accounting policies applied to this category of structured finance activities. More specific policy disclosures included examples of transactions where derecognition is achieved, risks of interests retained, types of instruments securitised and valuation assumptions used to calculate the carrying values. The following extract provides a tailored example of derecognition and securitisation accounting policy disclosures:

Extract 14: Illustration of disclosure of recognition, derecognition and securitisations – UBS.

4) Recognition and derecognition of financial instruments

UBS recognizes financial instruments on its balance sheet when the Group becomes a party to the contractual provisions of the instrument.

UBS enters into transactions where it transfers financial assets recognized on its balance sheet but retains either all risks and rewards of the transferred financial assets or a portion of them. If all or substantially all risks and rewards are retained, the transferred financial assets are not derecognized from the balance sheet. Transfers of financial assets with retention of all or substantially all risks and rewards include, for example, securities lending and repurchase transactions described in this Note under parts 12) and 13). They further include transactions where financial assets are sold to a third party with a concurrent total rate of return swap on the transferred assets to retain all their risks and rewards. These types of transactions are accounted for as secured financing transactions.

In transactions where substantially all of the risks and rewards of ownership of a financial asset are neither retained nor transferred, UBS derecognizes the financial asset if control over the asset is lost. The rights and obligations retained in the transfer are recognized separately as assets and liabilities as appropriate. In transfers where control over the financial asset is retained, the Group continues to recognize the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset. Examples of such transactions are transfers of financial assets involving guarantees, writing put options, acquiring call options, or specific types of swaps linked to the performance of the asset.

UBS removes a financial liability from its balance sheet when it is extinguished, i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Assets held in an agency or fiduciary capacity are not assets of the Group and are not reported in the Financial Statements, provided the recognition criteria of IFRS are not satisfied.

11) Securitizations

UBS securitizes various financial assets, which generally results in the sale of these assets to special purpose entities, which in turn issue securities to investors. UBS applies the policies set out in part 4) in determining whether the respective special purpose entity must be consolidated and those set out in part 3) in determining whether derecognition of transferred financial assets is appropriate. The following statements mainly apply to financial asset transfers that are considered true sales to non-consolidated entities.

Interests in the securitized financial assets may be retained in the form of senior or subordinated tranches, interest-only strips, or other residual interests ("retained interests"). Retained interests are primarily recorded in Trading portfolio assets and carried at fair value. Gains or losses on Securitization are recognized in Net trading income, which is generally when the derecognition criteria are satisfied. Typically, the Group seeks to exit its risk in retained interests shortly after close of the securitization. The Group is also an active market maker in these securities and may therefore subsequently reacquire interests in the assets it securitizes. Financial assets purchased with the intention of securitizing them in the future, often referred to as warehousing assets or loans, are generally reflected in Trading portfolio assets, with changes in fair value recognized in net trading income. Synthetic securitization structures typically involve derivative financial instruments for which the principles set out in part 14) apply. Purchased asset-backed securities (ABS), including mortgage backed securities (MBS), originated by third parties are recognized as financial assets held for trading, or in a minority of cases, as financial investments available-for-sale.

UBS securitizes residential and commercial mortgage and other assets, acting as lead or co-manager. In addition, UBS acts as warehouse agent, structurer and placement agent in various collateralized debt obligation (CDO) and collateralized loan obligation (CLO), MBS and other ABS securitizations. In such capacity, UBS may purchase collateral on its own behalf, or on behalf of customers during the period prior to securitization. UBS typically sells the collateral into designated trusts at the close of the securitization and underwrites the offerings to investors. UBS earns fees for its placement and structuring services. For residential mortgage loan and other securitizations, the investors and the securitization vehicle generally have no recourse to UBS's other assets for failure of loan holders to pay when due.

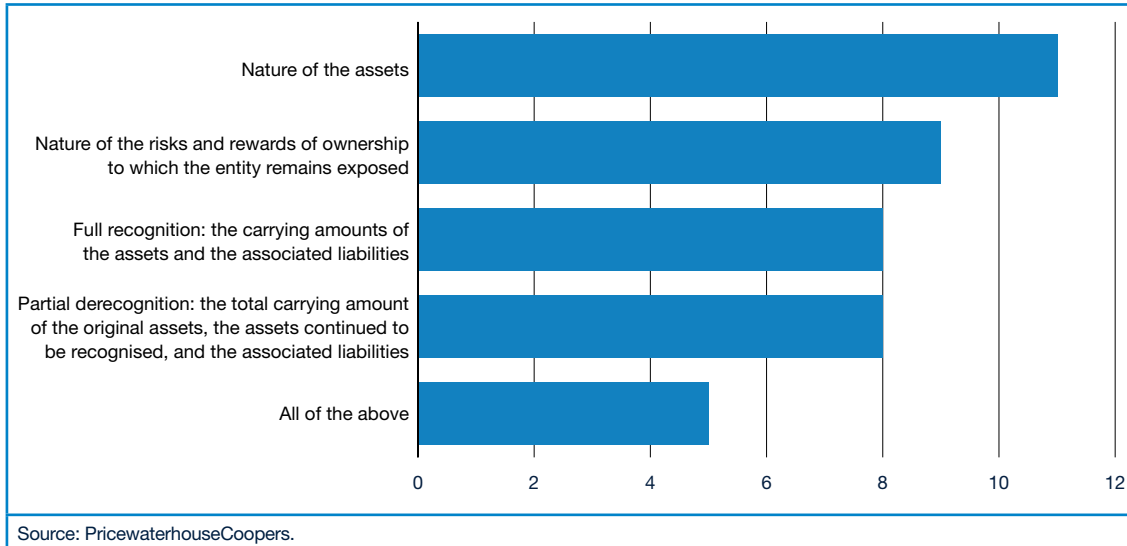
Consistent with the valuation of similar inventory, fair value of retained tranches or warehousing assets is initially and subsequently determined using market price quotations where available or internal pricing models that utilize variables such as yield curves, prepayment speeds, default rates, loss severity, interest rate volatilities and spreads. The assumptions used for pricing are based on observable transactions in similar securities and are verified by external pricing sources, where available.

Source: UBS Annual Report 2007.

Securitisation – quantitative disclosures

Varying levels of quantitative disclosures surrounding securitisation activities were provided by 18 of the surveyed banks. Those that transferred financial assets that were not derecognised under IAS 39 provided the following disclosures under IFRS 7.

Figure 8: Disclosures on assets not qualifying for derecognition.



The figure above outlines how the surveyed banks applied specific requirements in IFRS 7 to securitisation activities where certain assets were not derecognised. While IFRS 7 requires disclosure of risks associated with assets that do not qualify for derecognition, it does not require disclosure of risks associated with those assets that do qualify for derecognition. In some cases, the risks associated with these off-balance sheet interests may present the greater risk to the bank.

As illustrated above, only nine of the 12 banks that disclosed assets not qualifying for derecognition provided information on the nature of the risks and rewards of ownership to which the entity remained exposed. Even when these details were provided, the disclosures in several cases did not provide a clear picture of the nature and extent of the risks that had been retained and of the risks that had been sold on.

Certain banks provided additional disclosures on their originated and non-originated structures. This information provided users with greater clarity on the extent of banks' contractual and non-contractual commitments and exposures. The format of these disclosures varied, but we found tabular disclosure formats easier to understand and analyse than disaggregated disclosure formats. The following extract provides an example of such tabular disclosure:

Extract 15: Illustration of additional disclosures provided in 2007 focusing on non-consolidated securitisation vehicles and collateralised debt obligations – UBS.

Non-consolidated securitization vehicles and Collateralized debt obligations – non-agency transactions ¹					
<i>CHF billion</i>	Total SPE assets			Purchased and retained interests held by UBS	Derivatives held by UBS
As of 31 December 2007	Original principal outstanding	Current principal outstanding	Delinquency amounts	Fair value	Fair value
Originated by UBS²					
CDOs and CLOs					
Residential mortgage	2.8	2.8	0.0	0.8	(0.1)
Commercial mortgage	6.0	6.0	0.0	0.2	0.0
Other ABS	12.8	³	0.0	5.3	0.0
Securitized					
Residential mortgage	2.9	2.6	0.2	0.4	0.0
Commercial mortgage	7.8	7.8	0.0	0.5	0.0
Other ABS	2.1	³	³	0.2	0.0
Total	34.4	³	³	7.4	(0.1)
Not originated by UBS					
CDOs and CLOs					
Residential mortgage	103.9	100.5	0.0	0.2	0.3
Commercial mortgage	38.8	35.1	0.0	2.0	(0.6)
Other ABS	51.5	³	0.0	11.5	(3.9)
Securitized					
Residential mortgage	742.6	³	16.9	21.4	0.2
Commercial mortgage	224.2	206.3	0.7	5.2	0.1
Other ABS	182.2	³	2.8	10.7	0.0
Total	1,343.3	³	20.4	51.0	(3.9)
1. Reflects material exposures. 2. Structures originated by UBS presented in this SEC disclosure include transactions within the scope of US GAAP, Financial Accounting Standard 140 paragraph 17. 3. Information is not available.					
Source: UBS Annual Report 2007.					

2.5 Concluding remarks

Overall, we noted an improvement in certain structured finance-related disclosures from our previous survey, notably in disclosures focusing on activities and related structures most impacted by market events (SIVs, CDOs, etc.). However, the range and level of detail of structured finance disclosures remained somewhat limited and did not present a complete picture of the scope and scale of the surveyed banks' respective activities.

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. A dialogue between the investor community, standard-setters, regulators and preparers should determine the information requirements of investors. Care should be taken to ensure that the appropriate balance is struck and to avoid mandating extensive detailed disclosures at the risk of overwhelming the user and masking the true exposure to risk. To increase transparency going forward, we have highlighted some potential disclosure enhancements that might form the basis to begin this dialogue.

Geography and principles or prescriptive guidance

- Consider whether disclosures should be included within the MD&A, audited financial statements, or ancillary reports (e.g. unaudited internet-based reporting).
- Consider whether the diversity of and varying level of structured finance disclosures could be improved with principles-focused vs. prescriptive guidance.

Nature of structured finance activities

- Provide tailored, qualitative information on the nature of exposure to structured finance activities to allow the user to better understand the business model, strategies and objectives of the activities.

Nature and level of bank's involvement in structured finance activities

- Provide quantitative and qualitative information of the bank's involvement with off-balance sheet entities, including disclosure of contractual support (e.g. liquidity and/or credit enhancement provided), and/or whether the bank is the sponsor of the activity.
- Provide more transparency surrounding the magnitude (in both amount and relative terms) of a bank's structured finance activities (by activity – SIV, CDO, ABCP). This could be provided in a quantitative format by outlining a bank's exposure in comparison to the size of the SPE and the related fees and expenses the activity generates.

Nature of bank's exposure to risks/rewards of structured finance activities

- Disclose quantitative information on the potential risk concentrations with respect to liquidity, capital resources or market and credit risk support, related collateral amounts and exposures before and after hedging as well as to the hedging counterparty.
- Disclose quantitative information relating to the type of collateral, industry and geographic distribution of collateral, average tenor of collateral, performance and credit ratings of the underlying collateral.

Application of bank's consolidation policy

- Provide additional information relating to management's consolidation policy, specifically the quantitative and qualitative assumptions utilised in the risk and rewards tests (which drives the consolidation assessment).

Bank's exposure to future events

- Provide quantitative information on the maximum exposure to loss for each significant structured finance activity and any related hedge (if applicable) that would mitigate the exposure.

- Provide qualitative and quantitative disclosures on the potential impact to the financial statements, debt covenants, capital ratios, credit ratings, collateral requirements or dividends, should the bank be required to consolidate any off-balance sheet entity or incur significant losses associated with the entity.
- Provide more frequent information for structured finance activities that do not perform as expected (e.g. lack of liquidity in commercial paper market).

In summary, while the current market dislocations have resulted in banks providing additional disclosures not seen in previous financial statements, the level of detail and clarity of the disclosures was not consistent from institution to institution and may not have provided the transparency that investors and regulators desire.

2.6 Future developments

The IASB, FASB, SEC and FSF have announced their desire to achieve additional transparency in the disclosure of off-balance sheet arrangements as well as certain changes to the accounting principles surrounding consolidation.

The IMF noted in its Global Financial Stability Report:²⁶

The ability of financial institutions to avoid consolidation – making it difficult for investors and regulators to detect these financial activities – suggests that standard setters need to reconsider the grounds for consolidation to improve the understanding of underlying risks by all parties.

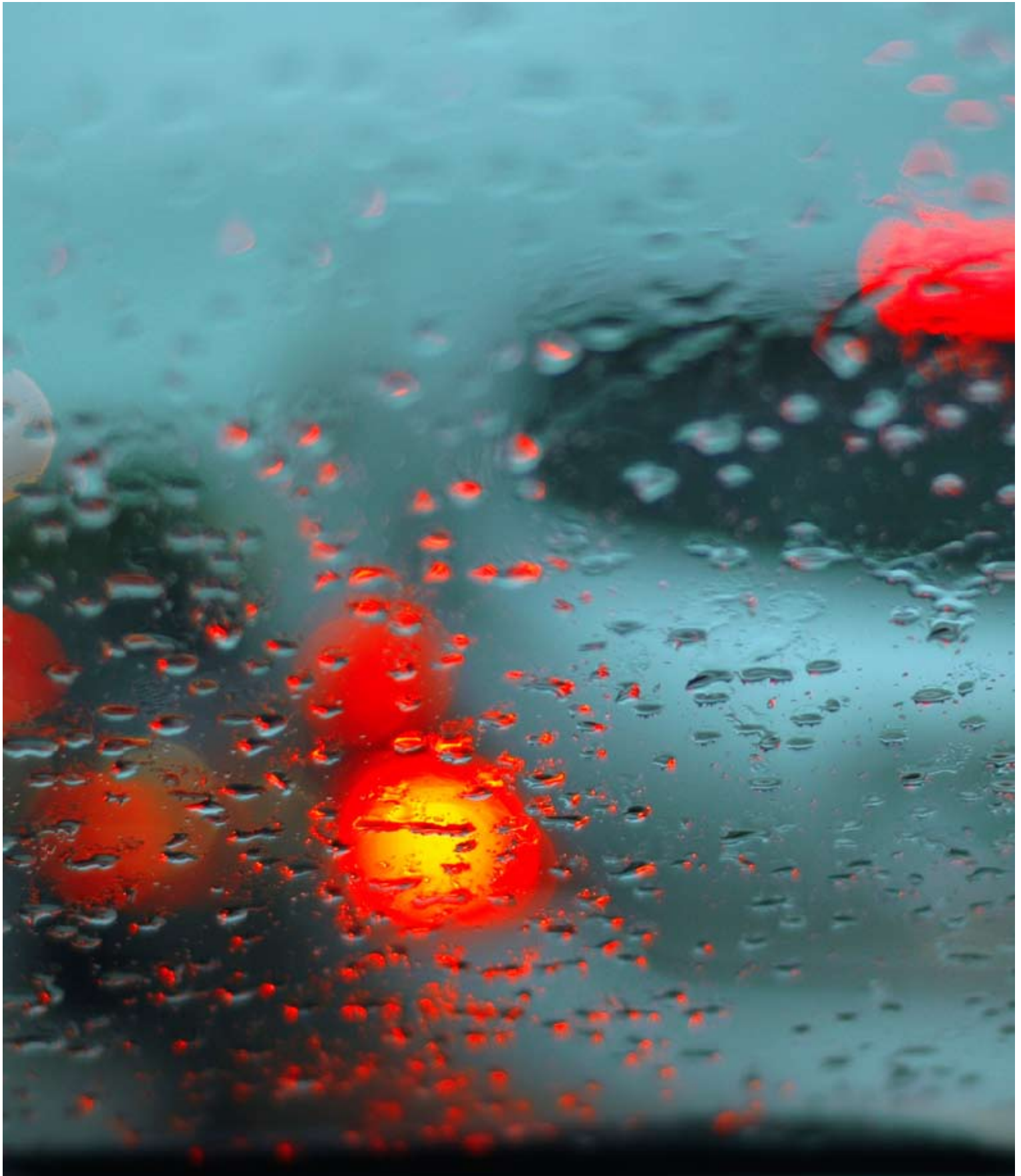
In its 2 April 2008 meeting, the FASB decided to remove the concept of a qualifying special purpose entity (QSPE) from SFAS 140. As a result, QSPEs would need to be evaluated for consolidation using the guidance in FIN 46(R). The FASB also decided to amend the derecognition criteria in SFAS 140 to improve financial reporting in the short term and to consider working on a joint derecognition research project with the IASB.

In its 9 April 2008 meeting, the FASB supported requiring a company to determine whether it should consolidate an entity (that is in the scope of FIN 46(R)) primarily using a qualitative model. A quantitative model would only be required if the qualitative assessment is not determinative. In addition, the Board agreed to rescind the current guidance for reconsidering consolidation only when a specifically defined reconsideration event occurs. Rather, reconsideration of consolidation/deconsolidation should be made each reporting period. The Board agreed to rescind the exemption from reconsideration of an entity in a variable interest entity in paragraph seven of Interpretation 46(R) for troubled debt restructurings.

The conclusions above, however, are tentative and may be changed at future FASB meetings; decisions become final only after a formal written ballot to issue a final statement.

Changes are also expected to the consolidation model under IFRS. In response to demands by regulators and other parties, the IASB staff plan to present a consolidation package integrating IAS 27 *Consolidated and separate financial statements* and SIC-12 *Consolidation – Special Purpose Entities*. The IASB's current plan is not to publish a discussion paper but to hold roundtables during September 2008 with the aim to publish an exposure draft in Q4 2008 and a revised standard in the second half of 2009.

26. The IMF World Economic and Financial Surveys, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness* – April 2008.



Risk management

3.1 Overview

With the recent market conditions and events, new emphasis is being placed by investors and regulators on the risks to which banks are exposed. In this environment, the quality of a bank's risk disclosures is under tremendous scrutiny. However, during the early stages of the market turmoil, public disclosures by financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures. This lack of adequate and consistent disclosure of risk exposures continues to have a corrosive effect on market confidence.²⁷

The IASB focused on the risk issue when it published IFRS 7 with the intent of giving investors 'information about an entity's exposure to risks and how those risks are managed'. IFRS 7 includes risk management disclosures that supersede those in IAS 32 and IAS 30, and became effective from January 2007.

Many of the banks in this survey were also influenced in their disclosures by additional guidance such as SEC regulations and Basel II. The impact of this guidance can be seen to varying degrees in their risk management disclosures. There is a large amount of overlap between these standards, which have similar objectives of providing transparency in the disclosure of risk exposures and risk management strategies. The SEC requirements are more prescriptive and detailed than the other guidance; however, they give a 'safe harbour' because they are not subject to the audit opinion.

This section focuses on identifying the problematic areas and best practice of a bank's risk disclosures, specifically relating to credit, liquidity and market risks. Disclosures around risk exposures and management were intended to assist in achieving transparency. Our survey identified a number of factors that made it difficult for this objective of transparency to be achieved:

- Banks adopted a compliance approach in the presentation of their risk disclosures;
- An overload of information was provided that was not tailored to the banks' specific risk management practices. Where information was disclosed, it was often not done in an easily accessible or usable way;
- While current market conditions undermined many of the assumptions banks used in managing risk, the banks' disclosures were not sufficiently detailed to discuss the impact these changes had on their understanding or their individual risk profile and related risk management strategies;
- The location of information provided was inconsistent, making it difficult for readers to easily find and compare information between peers;
- Risk management disclosures were not rebuilt to properly incorporate the new IFRS 7 requirements in a clear and cohesive way. Many banks simply added required disclosures into existing risk management discussions without providing a clear linkage between the qualitative and quantitative components;
- Some of the requirements prescribed in IFRS 7 were not aligned to the way that banks actually manage risk.

27. The FSF, *Enhancing Market and Institutional Resilience* issued to the G7 Ministers and Central Bank governors – 07.04.2008.

3.2 What we saw in our last survey

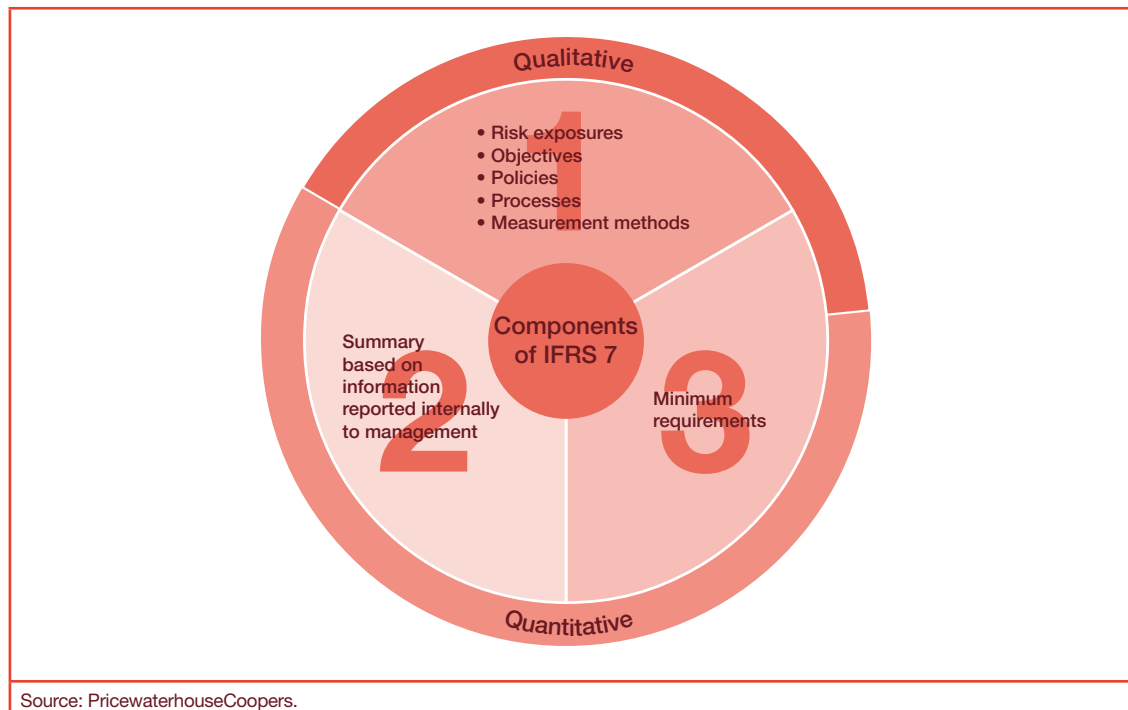
In our previous survey we observed that the adoption of IFRS had not significantly impacted the disclosure of risk management activities of the surveyed banks. Extra disclosure was qualitative rather than quantitative in nature. Two of the surveyed banks early adopted IFRS 7, however, it was too early to draw observations on the impact that the new standard had on the banks' risk disclosures.

3.3 Components of IFRS 7

IFRS 7 can be split into three distinct components:

1. Qualitative disclosures. The standard requires an analysis of the types of risks that a bank is exposed to, including its objectives, policies and processes for managing those risks, and how the risks are measured.
2. Summary of quantitative data as provided internally to key management personnel. This is where the standard takes a more principles-based approach as it requires companies to report the information they use internally to help them identify and manage their financial instrument exposures. Management therefore determines what disclosures to make based on its internal systems. This can be quite sensitive as it means revealing externally strategic information that was previously just internal.
3. Quantitative and qualitative minimum requirements as prescribed by the standard.

Figure 9: Components of IFRS 7.



Source: PricewaterhouseCoopers.

3.3.1 Qualitative disclosures

Typically, banks have provided a detailed narrative breakdown and analysis of their risk management processes and policies. Banks adopted a similar approach and presentation of this discussion. We did not find any notable changes to these areas based on the introduction of IFRS 7.

3.3.2 Quantitative disclosures – as reported internally to management

We found that there was very little focus on this particular area in the surveyed banks' financial statements. There were no specific references made to the quantitative information reported internally to management. This section merged in with the overall risk management disclosures and was overshadowed by the attention given to meeting the minimum requirements during the first year of adoption of IFRS 7.

The fact that banks often had to develop new processes to produce the data necessary to populate the minimum requirements, combined with other time pressures, perhaps meant that there was less scope to produce a quality discussion of the information reported internally to management, and this led the banks to adopt a more compliance-based approach. In addition, due to the strategic nature of their risk management information, one might anticipate that the banks would be reluctant to present more than the minimum requirements, given that this was the first year of implementation of the standard and also given the recent market conditions.

3.3.3 Minimum requirements – as imposed by IFRS 7

In addition to the standards' intention to provide insight into how management actually manages risk, minimum disclosure requirements were also imposed. The next section looks at these requirements in more detail as we perform an assessment of how well the banks complied with the various minimum risk disclosures.

Our survey revealed that the prescribed minimum requirements led to a more compliance-driven approach by the banks, and perhaps focused the banks on the wrong kind of disclosures. It found that there was not a clear linkage between the newly added disclosures and the existing risk management discussion carried over from previous years. Typically, the banks added additional quantitative disclosures in the form of tables without related commentary. In some cases, some of the old requirements under IAS 30/32, though no longer required under IFRS 7, were still included. We also found that some of the requirements prescribed in IFRS 7 were not aligned to the way that banks actually manage risk; this was particularly evident for the liquidity risk disclosures as noted below. The combination of these points meant that a coherent story of how the banks managed their risks was not clearly communicated.

3.4 IFRS 7 minimum requirements assessment

The following tables summarise the minimum requirements in IFRS 7, as prescribed in paragraphs 36–42, for each of the three risk categories used: credit, liquidity and market. We have assessed each requirement on the basis of whether we found the disclosure to be a problematic area, across a scale of one to three, as evidenced by:

- The number of variations from the particular disclosure requirement across the banks sampled;
- The level of detail and analysis provided;
- An explicit statement that the disclosure made by the entity differed from that required by the standard.

Scale

Not problematic  Problematic  Most problematic 

3.4.1 Credit risk

As in prior years, the banks disclosed a detailed analysis of their exposure to, and management of, credit risk. Most of the new minimum quantitative requirements relate to this area and are intended to give a reader better insight into the overall quality of financial assets. For the purpose of this survey, we have broken the credit risk disclosures into four categories: total exposure and performing assets; past due/impaired; collateral; renegotiated assets.



Our assessment of how well the banks complied with the credit risk requirements is as follows:

(i) Total credit exposure and performing assets

IFRS 7 requirement	Rating	Comments
Maximum exposure to credit risk without taking account of any collateral held (or other credit enhancements).		Maximum exposure to credit risk is adequately disclosed. For almost all the banks the concentration of risk was disclosed by product type, industry sector and geographic region. The analysis included assets and off-balance sheet items.
Information about the credit quality of financial assets that are neither past due nor impaired.		The credit quality of financial assets that are neither past due nor impaired is adequately disclosed. Amounts were disclosed per rating using a combination of internal and external ratings.

(ii) Past due and impaired financial assets

As financial assets move into a past due state, additional disclosures are required to assist the reader in understanding the health of the asset portfolio and provide visibility into the likelihood of those assets becoming impaired.

IFRS 7 requirement	Rating	Comments
Analysis of the age of financial assets that are past due but not impaired.		The ageing analysis of financial assets that are 'past due' was adequately disclosed. The time bands in the ageing analysis varied, which is expected, given that IFRS 7 does not prescribe the way in which the time bands should be presented. Five banks provided a short description of what types of situations would lead to a financial asset being categorised as past due. For example, late processing and other administrative delays.
Analysis of individually impaired financial assets, including the factors considered in determining that they are impaired.		Most banks provided a table that showed a breakdown of the financial assets that are individually impaired. However, there was very little related commentary. Some discussion about the individually impaired assets may have been presented elsewhere in the report, such as in the accounting policies or risk management section. Otherwise, there was not much focus given to this area. We believe that a commentary on the criteria for determining impairment across the different business units of the bank would be instructive.

(iii) Collateral

IFRS 7 requires detailed collateral disclosure including carrying amount, fair value and contractual terms. In meeting these requirements, banks used a wide range of formats and disclosed a widely divergent amount of information.

IFRS 7 requirement	Rating	Comments
Description of collateral held or other credit enhancements		A summary description of collateral is provided in the credit risk management section, along with the discussion of other credit risk mitigating instruments. However, many of the banks did not provide a detailed description of the associated collateral and collateral risk.
For financial assets that are past due and individually impaired, a description of collateral held and other credit enhancements and, unless impracticable, an estimate of their fair value.		<p>The disclosure around collateral is considered to be a problematic area because of the inconsistent presentation made by the banks and, in some cases, the insufficient details provided. Banks typically did not present up-to-date information on the fair value of collateral. Half of the IFRS reporting banks surveyed did not provide a description of the fair value of collateral associated with past due and impaired loans. One bank stated that the fair value was not disclosed for its corporate mortgage loans because it is impracticable to do so. A common approach was to state that the fair value is the lower of the collateral value and the outstanding balance of the asset.</p> <p>We believe that it would be more meaningful for a reader to know the extent of over- or under-collateralisation rather than an aggregate fair value number. We also believe that a sensitivity analysis of collateral valuations would be meaningful.</p>
<p>For collateral repossessed during the period (financial or non-financial assets), which also meets the recognition criteria in other IFRS standards, banks must disclose:</p> <p>(i) the nature and carrying amount of the asset obtained and</p> <p>(ii) when the assets are not readily convertible into cash, policies for disposing or for using them in operations</p>		<p>There was little evidence of discussion around repossessed collateral. Most banks disclosed the carrying amount of residential, commercial and industrial properties. Many of the banks did not make any reference to repossessed collateral and one bank stated that the amount was not material.</p>



(iv) Renegotiated assets

The surveyed banks varied widely in their interpretations of which loans to include within this disclosure.

IFRS 7 requirement	Rating	Comments
The carrying amount of renegotiated financial assets that would otherwise have been past due or impaired.		<p>Disclosures relating to renegotiated financial assets proved to be a problematic area, due to the inconsistent presentation made by the banks. As explained by some banks, 'renegotiation results in the asset continuing to be impaired and therefore did not disclose any carrying amounts'. Another bank disclosed the total amount of loans that had been renegotiated in the last 12 months. Some banks did not make any reference to renegotiated financial assets.</p> <p>Our survey revealed that the standard needs to be improved in this area to clarify the objective of this particular requirement, since it poses a hypothetical question that has been difficult to answer. Narrowing the disclosure to only those renegotiated assets that 'would otherwise have been past due or impaired', not only created confusion but also limited the discussion.</p>



3.4.2 Liquidity risk

The liquidity risk disclosure in IFRS 7 consists of two paragraphs and requires a maturity analysis of financial liabilities and disclosure of liquidity risk management strategies. However, the requirement to prepare the maturity analysis on an undiscounted basis using expected settlement maturity dates proved to be a challenge for many banks. Our assessment of how well the banks complied with the liquidity risk requirements was as follows:

IFRS 7 requirement	Rating	Comments
Liquidity risk		
Maturity analysis for financial liabilities that shows remaining contractual maturities based on contractual undiscounted cash flows.		<p>The disclosure of derivatives and trading liabilities was a problematic area. Six banks classified these financial liabilities in the 'on demand' column and not at their contractual maturity dates. These particular banks explained the rationale for such disclosure – that derivatives are not held for settlement according to maturity and are frequently settled before contractual maturity. Ten of the surveyed banks disclosed derivatives and trading liabilities according to their contractual maturities.</p> <p>The presentation of the liquidity table was not user-friendly. In some cases, it was not clearly stated whether the amounts in the liquidity table were on an undiscounted basis. In some instances, more than one liquidity table was presented. The other table(s) was (were) primarily based on the previous requirement under old GAAP, in IAS 30.</p> <p>There was limited discussion, and in some cases none at all, about how certain financial instruments were presented in the liquidity risk table, given that for some instruments it was not a straightforward task, such as:</p> <ul style="list-style-type: none"> • gross vs net settled derivatives • financial guarantees • coupon payments • perpetual liabilities <p>Six of the surveyed banks included off-balance sheet items such as loans and other commitments in the analysis, but separated them from the other categories. It was not clear whether financial guarantees were included in the liquidity analysis, given that there was no specific commentary about such instruments. Eight banks did not include off-balance sheet items in the liquidity table.</p> <p>Overall, the liquidity table did not aid transparency and it did not assist in obtaining a better understanding of the banks' risks. It might have been useful to disclose the expected variations in the value of derivatives as opposed to disclosing only the position at the balance-sheet date.</p>
Description of managing liquidity risk inherent in the maturity analysis required above.		<p>The discussion of the liquidity risk management practices is of a generic nature and generally appears in the front part of the annual report. There is no specific commentary on how liquidity risk is managed in line with the quantitative information presented in the liquidity table. In addition, there is little discussion on how risk management strategies have changed in reaction to the current liquidity crisis. Many banks still discuss the availability of short-term funding to manage liquidity needs.</p> <p>We believe that the following recommendations on liquidity would assist in providing meaningful information:</p> <ul style="list-style-type: none"> • Description of main sources of liquidity, including policies of managing liquidity sources • Concentration analysis • Sensitivity analysis/stress test of liquidity

3.4.3 Market risk

As in prior years, the banks continued to disclose a detailed analysis of value-at-risk (VAR) as a risk management tool. However, any sensitivity disclosure for risks that were not managed by VAR was not clearly presented or easy to follow. Our assessment of how well the banks disclosed market risk requirements was as follows:

IFRS 7 requirement	Rating	Comments
<p>Market risk</p> <p>If a bank uses VAR as its sensitivity analysis (or a sensitivity analysis that reflects interdependencies between risk variables), it must disclose this analysis together with an explanation of the method, main parameters and assumptions underlying the data provided.</p> <p>A bank must also disclose an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting fair value.</p>		<p>Banks use VAR as a tool to manage interest rate, foreign exchange, commodity, credit and equity risk. VAR values are provided for year-end, showing the average, minimum and maximum amounts. There is a detailed discussion about VAR and other risk management tools used by the banks such as risk limits, daily oversight and stress testing.</p> <p>We expected to see more discussion from banks about the limitations of using VAR as a risk management tool in the context of the current market environment. We also expected more discussion about model recalibration and whether limits were exceeded.</p>
<p>If a bank does not use VAR or comply with the above requirement, it must disclose the sensitivity analysis for each type of market risk to which the bank is exposed, showing how P&L and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date. It must also disclose the methods and assumptions used as well as any changes to these methods and assumptions from the previous period.</p>		<p>In addition to the VAR disclosures, 11 of the surveyed banks provided a sensitivity analysis for non-trading interest rate risk. Only four of these banks disclosed the impact on both the P&L and equity. The banks' interpretations of a reasonable possible shift in interest rates varied significantly. Some banks applied 1bp; others applied 50bps, 100bps or 200bps.</p> <p>It was difficult for a reader to identify this particular sensitivity analysis in the market risk section. It did not prove to be a particularly meaningful or relevant disclosure as the assumptions and methods used were not disclosed in detail. Only a basic understanding of a single risk sensitivity analysis was obtained.</p>

3.5 Location of risk management disclosure in the annual report

With IFRS 7 incorporating risk management disclosures within the audited financial statements, many banks included the required disclosures within the notes to the financial statements. This presentation was not required by the standard and, as a result, the information was not sited in a consistent location in each annual report. In addition, the traditional inclusion of these disclosures within the MD&A section, as required by the SEC, made many of the banks reluctant to move them. This meant that risk disclosures were often split into two sections, the MD&A and notes to the financial statements. In many cases, we noted that the information presented was duplicated in each of these sections. We found it difficult for a reader to know where to locate the IFRS 7 risk disclosures in the annual report, which made performing a comparison between the banks challenging.

In order to deliver a coherent story of a bank's risk management strategies, and provide comparability among peers, each bank might want to consider whether it requires related disclosures to be presented in the same location. An additional issue is whether the disclosures are best presented within or outside the financial statements. This particular issue was raised during the development stage of IFRS 7. Many respondents argued that disclosures about risks should not be part of the financial statements for the following reasons:²⁸

- (a) The information would be difficult and costly to audit.
- (b) The information is different from information generally included in financial statements because it is subjective, forward-looking and based on management's judgement. Thus, the information does not meet the criteria of comparability, faithful representation and completeness.
- (c) Inclusion of such information in a management commentary section outside the financial statements would be consistent with practice in other jurisdictions, including the US. Having this information in the financial statements would put IFRS preparers at a disadvantage relative to their US peers.

However, the IASB's view was that financial statements would be incomplete and potentially misleading without disclosures about risks arising from financial instruments. Hence, it concluded that such disclosures should be part of the financial statements.²⁸

3.6 Recent market conditions and the impact on risk management disclosures

In their risk management disclosures, the banks surveyed made reference to the key market risk issues in the current environment. There were discussions, for example, about the impact of the US subprime market, exposures to monoline insurers, liquidity facilities, credit spreads and structured products. While there was information about the higher risk areas on which markets are focused, the information did not seem to set out a unified and complete story on how the market turbulence affected the individual banks. That may be due to the common practice of structuring management commentary around results for individual business segments rather than directly analysing developments in group level performance and financial condition. We believe that there is scope for banks to improve the way in which they communicate the overall position in the future.

We noted that there was very little discussion about which risk management practices during the period of market turmoil worked well and which did not. Nor was there much discussion about adapting risk management processes to reflect current circumstances.

3.7 Basel II: Pillar 3 – 'Market Discipline'

Basel II Pillar 3 – 'Market Discipline' is a disclosure requirement developed by the Basel Committee on Banking Supervision. It was designed to address the issue of improving market discipline through quality public disclosure. The European Commission has also legislated Pillar 3 as part of the revised 'Capital Requirements Directive' (CRD), which was adopted on 14 June 2006. The European rules of Pillar 3 largely correspond to those of Basel II, although there are some minor differences in individual areas, such as terminology and disclosure frequency.

²⁸. *Basis for conclusions*, IFRS 7.

The objective of Pillar 3 disclosures is to provide increased visibility into an entity's risk profile and the adequacy of its risk management practices, by requiring banks to disclose information consistent with the views of management. In this respect there are similarities with the requirements of IFRS 7, in that both frameworks emphasise the importance of disclosed risk information being consistent with the view of management, and both require qualitative and quantitative information to be disclosed around the banks' market and credit risk practices.

This overlap is recognised in the Basel Accord, which states that 'in a situation where the disclosures are made under accounting requirements or are made to satisfy listing requirements promulgated by securities regulators, banks may rely on them to fulfil the applicable Pillar 3 expectations'. In its drafting of IFRS 7, the IASB has also attempted to enhance these synergies and reduce potential redundancies between the two standards. The results of these efforts are most evident in the areas of credit and market risk, where the majority of the qualitative disclosure requirements are aligned. To a lesser extent there are also overlaps in the quantitative requirements in the analyses of credit risk exposures and VAR measures.

Despite these broad similarities, these standards do have different objectives: IFRS 7 is focused on achieving greater transparency about the risks that entities run through the use of financial instruments and on providing better information for investors and other users of financial statements to make informed judgements about risk and return: Pillar 3, on the other hand, has a slightly broader mandate, which is to facilitate the prudential supervision of banks through a robust disclosure framework aimed at enhancing the operation of market discipline in the financial system. These differing objectives have given rise to a number of key differences that are highlighted in the table below.

Scope	<p>The vast majority of Pillar 3 disclosures are only required at a consolidated level and encompass all risks and risk exposures that arise or might arise in a credit institution. IFRS 7 must be disclosed for all entities and applies only to financial instruments and risks arising from such instruments.</p> <p>This scope divergence between the two standards is manifested in the differing disclosure requirements for operational and liquidity risk. Pillar 3 requires disclosures related to operational risk, but not to liquidity risk. IFRS 7 requires disclosures related to liquidity risk, but not to operational risk.</p>
Market risk	<p>Pillar 3 focuses on the capital requirements for each type of market risk and requires details of models used and stress testing performed. In contrast, as described previously, the objective of the IFRS 7 disclosure requirements in this area is to provide an indication of how profit and loss would have been affected by changes in market risk variables that were reasonably possible at the reporting date.</p>
Credit risk	<p>Although similar in many respects, Pillar 3 disclosures on credit risk are much more prescriptive and extensive than those required under IFRS 7, particularly for those banks applying the 'Internal Ratings-Based Approach' (IRB) for calculation of minimum capital requirements.</p>
Securitisations	<p>There are no specific disclosure requirements in IFRS relating to securitisations, whereas Pillar 3 includes a 16-point list of disclosures for such transactions including: accounting policies; total outstanding exposures by type; impaired and past due amounts; amounts retained or purchased by type and risk weight bands; revolving exposures; activity in period.</p>

The CRD does not mandate a specific deadline for banks to comply with Pillar 3 disclosure requirements; the flexible timetable approach allows banks to implement the requirements of Pillar 3 at any time between 2007 and 2009. In the US the first phase of Basel II implementation is not scheduled until 2009.

Not surprisingly, the vast majority of surveyed banks have not elected to 'early adopt' Pillar 3 and will likely begin to make their first required disclosures over the coming year. While it is too early to identify specific trends, we do expect compliance with Pillar 3 requirements to have a positive impact on the overall transparency of risk disclosures.

3.8 Concluding remarks

Providing quality, transparent, risk management disclosures has always been a challenging task for banks. To be meaningful to the reader, these disclosures should reflect the current market conditions and their impact on the bank's risk profile. A principles-based approach will be required to allow the flexibility necessary to meet these changing demands in a timely manner. An important first step in accomplishing that goal was the concept introduced by IFRS 7 of externally reporting the information used internally by management to manage risk. In this way, banks are required to tailor their disclosures to their own risk profile and management strategies.

While this was not fully accomplished in the first year of adoption, we expect these disclosures to evolve over the coming years, particularly as banks face increasing pressure from the market and in response to reports issued by the FSF and the IASB's review of the application of IFRS 7. We expect the adoption of additional guidance such as Basel II: Pillar 3 to further strengthen the quality of risk management disclosures.

Enhanced disclosure by banks of more meaningful and consistent quantitative and qualitative information about risk exposures, risk management and related policies would be very useful in restoring market confidence. This will require firms to maintain appropriate internal firm-wide risk measurement systems to deliver meaningful and timely risk disclosures.

3.9 Future developments

At the time of writing, the IASB has not made any public announcements relating to the future developments of the risk section in IFRS 7. However, given that the IASB is revisiting the disclosure requirements in the standard, we consider it to be a good opportunity to reflect on whether the required risk disclosures achieved the desired objectives and how they can be improved. We support the need for further dialogue among the various parties in order to improve transparency of banks' risks disclosures. Additional guidance will be based on lessons learnt from the recent turbulence, including shortcomings in risk management tools, and from the problematic areas identified with the adoption of IFRS 7, together with an early assessment of the implementation of Basel II.

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