FSB FINANCIAL STABILITY BOARD

Thematic Review on Risk Disclosure Practices

Peer Review Report

18 March 2011

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Foreword

The peer review on risk disclosure practices is the second thematic review under the Financial Stability Board (FSB) *Framework for Strengthening Adherence to International Standards*.[1]

In 2008 the Financial Stability Forum (FSF) recommended improved disclosures about structured credit products and certain other risk exposures that were of concern to market participants at that time. In March 2010, the FSB launched a peer review of the implementation of these recommendations. This peer review examines both financial institutions' public disclosures of risk exposures as well as the actions undertaken by FSB member jurisdictions and the private sector participants to enhance the relevant disclosure practices.

This report describes the findings of the thematic review on risk disclosure practices, including the key elements of the discussion in the FSB Standing Committee on Standards Implementation (SCSI). The draft report for discussion was prepared by a team chaired by Shyamala Gopinath (Reserve Bank of India), comprising Linda Ditchkus (Board of Governors of the Federal Reserve System), Paul Ebling (UK Financial Services Authority), Theresa Kwan (Hong Kong Monetary Authority), Erik van der Plaats (European Commission), and Alexander Szmigin (UK Financial Services Authority). Gerald Edwards, Jr. (FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

The findings of this review are based on responses to a questionnaire (Annex 2) designed to gather information from FSB member jurisdictions on the implementation of the FSF's risk disclosure recommendations. In addition, the review benefited from input from financial institutions, industry associations, and other stakeholders on practical experiences as users of the resulting disclosures or in implementing the risk disclosure recommendations, as well as from discussion in the FSB SCSI and in the FSB Plenary.

[1] http://www.financialstabilityboard.org/publications/r_100109a.pdf .

FSB thematic peer reviews

The FSB has established a programme of thematic peer reviews of its member jurisdictions. Each review surveys and compares the implementation across the FSB membership of regulatory or supervisory measures in a particular policy area important for financial stability. Thematic peer reviews focus on implementation of international financial standards, policies agreed within the FSB or, where such standards or agreed policies do not exist, a stock taking of existing practices in the policy area. The objectives of the reviews are to encourage consistent cross-country and cross-sector implementation, to evaluate the extent to which standards and policies have had their intended results and, where relevant, to make recommendations for potential follow up by regulators, supervisors and standard setters. They provide an opportunity for FSB members to engage in dialogue with their peers and to share lessons and experiences.

Thematic peer reviews complement FSB country peer reviews, which focus on the progress made by an individual FSB member jurisdiction in implementing IMF-World Bank Financial Sector Assessment Program (FSAP) regulatory and supervisory recommendations.

Executive summary

The financial crisis highlighted that reliable and relevant valuations and disclosures of the risks to which financial institutions are exposed are important to maintain overall market confidence. High quality risk disclosures contribute to financial stability by providing investors and other market participants with a better understanding of firms' risk exposures and risk management practices.

With that in mind, in April 2008 the FSF's report on Enhancing Market and Institutional Resilience[2] recommended that financial institutions with significant exposures to structured credit products and certain other on- and off-balance sheet risk exposures provide additional risk disclosures, and identified leading practices in this regard.[3] The FSF also encouraged the Basel Committee on Banking Supervision (BCBS) to strengthen the Basel II Pillar 3 disclosure requirements for exposures to securitisation vehicles, sponsorship of off-balance sheet vehicles, liquidity commitments to asset-backed commercial paper (ABCP) conduits, and valuations. Moreover, the FSF recommended that investors, financial institutions and auditors should work together to develop principles and specific risk disclosures for key risks that would be most relevant to the market conditions and risk exposures at reporting dates in the future.

[2] http://www.financialstabilityboard.org/publications/r_0804.pdf

[3] The review does not assess issuers' risk disclosures relating to offerings of structured credit products.

This thematic review assesses implementation of these recommendations by the 24 FSB member jurisdictions and by the major financial institutions located in those jurisdictions. The FSB collected information on implementation through a review template (questionnaire) sent to its member jurisdictions. The FSB also publicly invited feedback from investors, audit firms, financial institutions, industry associations and other stakeholders on their practical experiences as users of the resulting disclosures or in implementing the risk disclosure recommendations. This review examines how disclosure practices at financial institutions have changed, areas where implementation has proven to be challenging, and initiatives that have been taken to improve disclosures. Based on the above assessment, the review sets out some initial considerations on the principles for disclosures about specific risks that have emerged since the FSF 2008 report and that require enhanced disclosure.

FSB members have used a variety of methods to communicate the FSF recommendations to financial institutions in their jurisdictions and to encourage enhanced disclosure practices for those with significant exposures. Financial institutions in nine of the 24 FSB member jurisdictions had significant risk exposures of the type identified in the FSF report and therefore were expected to provide the recommended risk disclosures.[4] Seven FSB member jurisdictions reported that, while financial institutions had made at least some of the disclosures, the authorities had either not reviewed whether any of the risk exposures were significant or concluded they were not significant.[5] The risk disclosures of 101 financial institutions were reviewed by the FSB. The key findings are:

- FSB members' actions have been helpful in focusing the attention of financial institutions on implementing the FSF's risk disclosure recommendations. This has improved risk disclosure practices related to structured credit activities, including exposures to special purpose entities (SPEs), asset backed securities (ABS), mortgage-backed securities (MBS) and collateralised debt obligations (CDOs). Standard setters and other organisations have followed up on the FSF recommendations, by issuing recommendations, guidance or standards to improve risk disclosures and related auditing practices.
- Most FSB members have already taken steps to implement the BCBS' enhanced Pillar 3 disclosures on time (ie by end-2011 or, in some cases, sooner). These enhanced disclosure requirements incorporate to a large extent, and are consistent with, the FSF recommendations for specific disclosures.
- Although firms' compliance with the FSF's recommended risk disclosures has generally been good, the quality of public risk disclosures varies across institutions and jurisdictions and there remains room for improvement. In particular there is room to improve disclosures on: 1) the descriptions of the use and objectives of SPEs used for securitisation, 2) off-balance sheet exposures of SPEs, 3) exposures both before and after hedging, and 4) the level of detail and granularity of the sensitivity analysis of securitisation exposures measured at fair value.

4 These FSB member jurisdictions are: Canada, China, France, Germany, the Netherlands, Korea, Switzerland, the United Kingdom and the United States.

5 These FSB member jurisdictions are: Australia, Japan, Hong Kong SAR, Italy, Russia, Saudi Arabia and Singapore. This includes Australia that bases risk disclosure requirements on materiality rather than significance.

- While standard setting bodies have improved their disclosure requirements since 2008, the FSF had also recommended that investors, financial institutions and auditors should jointly develop risk disclosure principles and should work together to identify enhancements in specific risk disclosures that would be most relevant given the recent evolution of market conditions. This has not happened.
- Different practices are followed across jurisdictions concerning the extent to which auditors provide assurance about risk disclosures in firms' financial reports and how that level of assurance is disclosed.

As a result of this review, the report makes the following recommendations:

1. Financial institutions should adopt, and jurisdictions should encourage adoption of, high-quality disclosure practices and thereby improve the consistency of risk disclosure. The FSB plans further work during 2011 to identify examples of leading practice disclosures based on a consideration of recent annual report disclosures.
2. The International Auditing and Assurance Standards Board (IAASB) should review whether there is a need for further guidance on the level of assurance provided by external auditors on risk disclosures, including those in the various sections of financial reports and public websites, and how that level of assurance is disclosed.
3. Banks and other credit institutions should improve their Pillar 3 disclosure practices. In particular they should: ensure timely publication of their Pillar 3 disclosures (preferably by aligning them with the publication date of financial reports) and provide useful information to enable users to navigate between Pillar 3 disclosures and relevant disclosures in financial reports.[6]
4. The FSB should facilitate work by investors, industry representatives and auditors to take the 2008 FSF recommendations forward by encouraging them to develop principles for useful risk disclosures as market conditions and risk profiles change.[7] To try to ensure that rapid progress is made in developing the principles, the FSB plans to organise during 2011 an international roundtable on risk disclosures that will bring together a broad spectrum of interested participants including standard setters, prudential authorities and market regulators, investors, accountants, auditors and economists.[8]
5. The FSB, drawing upon its members' expertise, should periodically evaluate emerging risks and vulnerabilities and make recommendations as needed to enhance risk disclosures by financial institutions. The FSB could build on its existing work to identify emerging risks and vulnerabilities by specifically considering whether there are areas where additional disclosures by financial institutions would help safeguard financial stability. Efforts involving international standard setting bodies and joint private sector initiatives will in many cases be the most appropriate manner to take those recommendations forward. The FSB should coordinate as necessary the alignment of the

[6] This should include cross references between financial reports and Pillar 3 disclosures and information that aligns the relevant terminology and explains the differences in the bases for these disclosures (eg consolidation).

[7] This report includes (in section 6 and Annex 4) some initial thoughts of the FSB on this subject.

[8] Should the planned roundtable not achieve sufficient progress in this area, the appropriate international standard-setting bodies will be asked to take forward work to consider principles.

activities of standard setting bodies to fill any gaps arising because of a lack of a timely response or from financial stability concerns.

6. The FSB should encourage investors, financial institutions, auditors and standard setters to work together to develop leading practice disclosures, including for the following risk exposures of current interest to markets: 1) concessional loan restructurings, 2) exposures to sovereign debt and to other financial institutions and 3) liquidity and funding positions.

1. Introduction

1.1 The FSF's 2008 recommendations

Following a request in October 2007 from the G7 Ministers and Central Bank Governors, the FSF undertook an analysis of the causes of the market turmoil and of the weaknesses of the financial system. The results of that analysis formed a basis for the recommendations in the report, *Enhancing Market and Institutional Resilience*, issued to the G7 Ministers and Governors in Washington in April 2008 (FSF 2008 Report).[9]

The FSF 2008 report explained that, during the early stages of the market turmoil and financial crisis, inadequate transparency about the risk exposures arising from structured credit products (including off-balance sheet entities) based on mortgage loans resulted in uncertainties that diminished market confidence and contributed to market behaviour detrimental to financial stability. This underscored the crucial importance of transparent and reliable disclosures about such exposures. To address this, amongst the recommendations in the report were recommendations designed to enhance transparency through improved risk disclosures about structured credit products and other crisis-related risk exposures.[10]

Those risk disclosure recommendations are set out in Annex 1, but to summarise:

- *Recommendation III.1*: The FSF's disclosure recommendations were built on the leading disclosure practices identified by the Senior Supervisors Group (SSG) and they focused on the most important types of structured credit exposures: exposures to CDOs, RMBS, CMBS, sub-prime and Alt-A exposures, leveraged finance, and SPEs.[11] The FSF's 2008 report recommended that a financial institution with a significant risk exposure to one of the structured credit products should, as a minimum, disclose qualitative and quantitative information about that exposure which is helpful in understanding the total on- and off-balance sheet risk exposures before and after write downs and hedging. The FSF called for these risk disclosures to be provided in reports starting in mid-year 2008.

  Although the recommendations were addressed primarily to financial institutions, the FSF's expectation was that its member jurisdictions would encourage high-quality compliance with the recommendations.

- *Recommendation III.2*: The FSF's risk disclosure recommendations addressed key matters requiring immediate attention based on current conditions and risks facing financial institutions in early 2008. The FSF recognised however that a more long-term solution was needed to identify and address significant emerging risks on a timely basis in the future. It therefore recommended that investors, financial industry representatives and auditors should work together to provide guidance on risk disclosures that are

[9] http://www.financialstabilityboard.org/publications/r_0804.pdf.

[10] Hereinafter, generally "structured credit products and other crisis-related risk exposures" are referred to as "structured credit products".

[11] The SSG disclosure report, dated 11 April 2008, can be obtained at the following website: http://www.financialstabilityboard.org/publications/r_0804a.htm. The report analysed disclosures by a sample of large internationally-oriented banks and securities firms; it did not analyse risk disclosures by other types of financial firms, such as asset managers.

relevant for market conditions at the time of the disclosure. In particular, the FSF recommended that:

- Investors, industry representatives and auditors should develop principles that should form the basis for useful risk disclosures.
- Investors, industry representatives and auditors should meet together, on a semi-annual basis, to discuss the key risks faced by the financial sector and to identify the types of risk disclosures that would be most relevant and useful to investors at that time.

- *Recommendation III.3*: Recognising the importance of improved disclosures about capital adequacy and risks, the FSF encouraged the BCBS to strengthen the Basel II Pillar 3 disclosure requirements for exposures to securitisation vehicles, sponsorship of off-balance sheet vehicles, liquidity commitments to ABCP conduits, and valuations. The FSF 2008 report noted that this work was underway.

In addition to the three FSF disclosure recommendations that form the main focus of this review, the FSF made further transparency-enhancing recommendations in its April 2008 report addressed to accounting and auditing standard setters, primarily the International Accounting Standards Board (IASB) and the IAASB. More generally, the report also contained recommendations to improve requirements for capital, liquidity, and risk management and to address the use of credit rating agencies.

1.2 The FSB's 2010 thematic review

In 2010, the FSB Standing Committee on Standards Implementation (SCSI) decided to conduct a thematic review to assess the implementation of the 2008 FSF recommendations by FSB member jurisdictions and major financial institutions. This report summarises the findings and recommendations of that work.

1.2.1 Review process

The FSB developed a review template/questionnaire (a copy of which is set out in Annex 2) based on the three FSF risk disclosure recommendations. The review template was designed to obtain information about:

- the members' activities and the magnitude of financial institutions' exposures related to structured credit products,
- the detail of the disclosures being provided (including examples of disclosures),
- the extent of qualitative information provided, and
- whether the disclosures provided were part of the published financial statements or were made publicly available through other means (e.g. in separate publications on the internet).

The review template was sent to the FSB member jurisdictions in June 2010 and all 24 members responded.

To complement the information from FSB member jurisdictions and to ensure there was an opportunity for public input, the FSB also sought direct feedback from investors, audit firms, financial institutions, industry associations, standard setters, and other interested parties. To facilitate this input, the FSB published a public invitation for feedback in July 2010 on the FSB's website.[12]

This public invitation requested feedback on how disclosure practices at financial institutions have changed, areas where implementation has proven to be challenging, and initiatives that have been taken to improve disclosures. Additionally, suggestions were requested for possible future approaches to enhance the communication amongst investors, financial institutions, audit firms, standard setters and regulators about principles for disclosure and further improvements in risk disclosure practices.

Eleven responses were received from a variety of stakeholders. Additional input was received through outreach with international investors. The FSB is grateful to all its members and those who responded to its public invitation for the time and effort they have spent assisting the FSB in this thematic review.

1.2.2 Structure of the Report

- The thematic review collected information about the actions supervisory and regulatory authorities from FSB member jurisdictions have taken to encourage implementation of the disclosure recommendations in the FSF 2008 Report. That information is summarised and discussed in Section 2.1.
- Section 2.2 summarises (a) the initiatives of risk disclosure standard setters since the 2008 FSF recommendation and (b) examples of other relevant contributions on risk disclosures by private participants.
- All of the efforts and activities mentioned in sections 2.1 and 2.2 of this paper are to encourage high-quality risk disclosure practices in key areas that were the focus of the 2008 FSF report. The thematic review has considered the risk disclosures provided and disclosure practices implemented subsequent to the FSF's recommendations. The results of this work are described in Section 3.
- The work by the BCBS to enhance the Pillar 3 disclosures requirements for re-securitisations was completed in July 2009. This thematic review has considered the progress made by FSB member jurisdictions in implementing those Pillar 3 enhancements. It also briefly discusses some aspects of existing Pillar 3 disclosure practice. (See Section 4).[13]
- This thematic review also examined the extent to which investors, market participants, industry and auditors have worked together to develop principles for meaningful risk disclosures and to provide guidance on updating risk disclosures; in other words, the extent to which Recommendation III.2 was implemented. This work is discussed in Section 5.

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[12] The FSF press release is available at http://www.financialstabilityboard.org/publications/r_0804.pdf.

[13] The BCBS' original implementation date was 31 December 2010, but this was subsequently revised to 31 December 2011.

On the basis of the discussion in those earlier sections, the FSB has concluded that further recommendations to enhance risk disclosure practices are required. Those recommendations are set out in Sections 5 and 6 of the report. In particular:

- Section 5 sets out recommendations on the need for stakeholders to play a pro-active role in promoting enhanced disclosure practices over time; and
- Section 6 and Annex 4 describe the FSB's initial views on the principles and practices to support leading practices going forward. Section 6 also identifies some disclosure issues that at this point need further attention.

2. FSB members' and standard setters' actions to implement the FSF recommendations

2.1 Key findings

- *FSB member jurisdictions took a number of actions—such as outreach efforts through speeches and press releases, issuing disclosure guidance and meetings with the leadership of major financial institutions—to support the FSF's 2008 risk disclosure recommendations and, more generally, to encourage high-quality risk disclosures.*
- *Generally, FSB member jurisdictions expected financial institutions with significant exposures to comply with the FSF recommended risk disclosures (in most cases on a consolidated basis) but allowed financial institutions to determine what was meant by a 'significant exposure'.*
- *Most supervisors and regulators took specific actions to monitor the implementation of the risk exposure recommendations and several supervisors and regulators also acted to promote enhanced disclosure for the future.*
- *On the basis of information received from FSB member jurisdictions in their thematic review templates, the FSB is of the view that members' actions increased the awareness of financial institutions of the FSF's risk disclosure recommendations and as a result the risk disclosure practices for structured credit products improved. The FSB believes, however, that there is room for further improvement in the risk disclosures provided.*
- *In response to the FSF recommendations a number of international standard setting bodies—such as the IASB, the IAASB, IOSCO, and the BCBS—and certain national standard setting bodies have issued standards and guidance in support of enhanced disclosures about structured credit products.*
- *In addition, after the FSF April 2008 report was published several industry organisations published disclosure principles and recommendations that sought to enhance risk disclosure practices.*

2.2 Activities undertaken by FSB member jurisdictions

Before the financial crisis some supervisory authorities recognised the need for additional publicly disclosed information about the risks involved with structured financing, and modified their reporting requirements accordingly. However, most supervisory authorities reacted during the market turmoil to understand first the extent of exposure within their own major financial institutions and the extent of the information gaps in their own countries and in jurisdictions that could affect their markets. Then, they took appropriate remedial actions.

After the FSF issued its disclosure recommendations in 2008, all supervisory authorities from FSB member jurisdictions conducted outreach efforts in support of the recommendations so as to promote implementation by financial institutions when the risk exposures involved were significant. The precise nature of these efforts varied among jurisdictions. Commonly-seen approaches included issuing press releases, speeches given by senior officials of FSB members, sending letters to financial institutions within their jurisdictions, and meeting with leadership of major financial institutions. Securities regulators also issued letters and guidance to listed companies to encourage them to improve disclosures about valuations, risk exposures, and related risk management practices. In some jurisdictions, supervisors and regulators also met with industry groups (Canada, France, Germany, Japan, Spain, United Kingdom, United States), public accounting firms (Japan, United Kingdom, United States), and accounting and auditing standard setters to introduce the recommendations and to discuss further steps that could be taken to improve publicly available information. To ease and promote adoption by their domestic financial institutions the French authorities converted the FSB recommendations into a French recommendation built around standardised templates. One supervisor (South Africa) asked banks to report measures taken to assess their exposure to subprime related exposures as well as the measures taken to mitigate the risks.

Exposure to structured credit products is not evenly spread throughout FSB member jurisdictions. For example, for the period under review, although nearly half of FSB member jurisdictions reported financial institutions with significant exposures of the kind addressed in the disclosure recommendations, other FSB member jurisdictions reported that no financial institutions within their jurisdictions had such significant risk exposures.[14] Moreover, even in jurisdictions that had financial institutions with significant risk exposures, the number of institutions with significant exposures varied. The extent of the activities undertaken by FSB member jurisdictions in support of the FSF recommendations varied depending on the extent of the exposures in that jurisdiction.

Potential weaknesses in structured credit products have also been addressed in some jurisdictions through legislative methods. For example, some FSB member jurisdictions currently prohibit holdings of certain high-risk products, and some prohibited financial institutions from creating or holding products with loan-to-value ratios above prescribed limits (to minimise exposures to certain high risk products and activities).

To enhance awareness, some supervisory authorities have provided transparency about the exposures in their markets and their evaluations and conclusions about those exposures by issuing publicly-available reports about those exposures.[15] For example, some supervisors have published aggregate information about risk exposures of financial institutions in their jurisdiction on their websites (Japan, Korea).

Entities expected to comply with the recommendations

Generally, FSB member jurisdictions expected financial institutions with significant exposures to structured credit products to comply with the FSF's relevant recommended disclosures in their public financial reports.

- In South Africa, the supervisor required *all* financial institutions to provide information about the risk exposures that are the subject of the FSF's recommended risk disclosures, regardless of whether the exposures were material to the institutions. South-Africa also mandated additional audit assurance on this information provided by banks.

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[14] There are several reasons for this, including: (a) the jurisdiction is an emerging market or has few globally active organisations, (b) differences in market structures, (c) the general degree of conservatism of the prudential supervisor (Brazil, India), (d) differences in risk attitudes of financial institutions, and (e) regulatory prohibitions on issuing or investing in certain instruments (Indonesia, China).

[15] For example, see http://www.fsa.go.jp/news/22/ginkou/20100930-5.html for a report issued by the Japan FSA.

- In the jurisdictions with large globally active financial institutions, generally only the major domestic and large globally active institutions were expected to comply with the recommendations. In these cases, smaller institutions did not typically have significant securitisation exposures.
- In some jurisdictions the focus was primarily on disclosures about the exposures of *banks*, whilst in other jurisdictions the reporting requirements and expectations for broker-dealers and insurance companies were the same as for banks. However, jurisdictions reported relatively few non-bank institutions as making disclosures about exposures to structured credit products. For example, FSB member jurisdictions reported only seven insurance companies and four securities firms as having made disclosures about exposures to structured credit products, compared to 90 banks and other credit institutions.
- In general, the recommended disclosures have been required on a consolidated basis, although some FSB member jurisdictions (eg Italy, Korea, Turkey and the United States) require them to be provided on both a consolidated and a solo-basis for banks. In India disclosures are made by banks on a solo basis when they are not the top consolidated entity in the banking group. Further, Indian banks with capital funds above a specified threshold are required to make interim disclosures at the solo level. To facilitate improved monitoring of financial institutions' risk exposures, the Hong Kong SAR authorities mandate semi-annual reports on these exposures.

Some FSB member jurisdictions reinforced these expectations about publicly available risk exposure information by incorporating elements consistent with the FSF's recommended risk disclosures in the required content of regulatory reports and by encouraging incorporation of the recommended risk disclosures into generally accepted accounting principles (GAAP).

Determination of significant exposures

The FSF's risk disclosure recommendations focus on 'significant' exposures. Generally, FSB member jurisdictions allow financial institutions to decide whether their exposures are significant for financial reporting purposes and do not prescribe quantitative definitions for significance. However, in Germany and the Netherlands, there has been a presumption that the major, internationally active financial institutions have significant exposures to structured credit products and, as a result, these financial institutions were required to make appropriate disclosures regardless of the actual size of their exposures.

In their responses to the FSB's review template, two FSB member jurisdictions outlined how they might interpret 'significant' exposures. One supervisor suggested that the threshold could be set at 10 percent of total capital. Another member organisation (the United Kingdom's Financial Services Authority; UK FSA) used 10 percent of core tier one capital as a threshold when deciding which financial institutions to evaluate for this thematic review.

Supervisors' monitoring actions

Supervisors generally found that merely encouraging institutions to comply with the FSF's risk disclosure recommendations was not sufficient and that follow-up activity was needed to ensure that disclosure practice developed appropriately. Accordingly, in addition to normal enforcement practices, supervisors and regulators in most FSB member jurisdictions undertook a variety of specific monitoring actions to ensure high-quality risk disclosures. In some FSB jurisdictions, this work has been carried out by securities regulators and in others by the direct supervisory authority (eg. the banking supervisor when evaluating a bank). For example:

- Most supervisors and regulators (Australia, Canada, France, Germany, Hong Kong SAR, Netherlands, United Kingdom, Italy, Japan, Saudi Arabia and the United States) performed targeted reviews on risk disclosures. In addition to the efforts of securities regulators, one supervisor (Netherlands) addressed shortcomings in risk disclosures in writing with the institutions involved but most supervisors discussed shortfalls in disclosure practices directly with the financial institutions and sometimes with the auditors either bilaterally or trilaterally.
- Some of supervisors have also integrated procedures to follow-up on disclosure weaknesses into their supervisory processes.

Supervisory actions to promote enhanced disclosure practices

Supervisory efforts have focused on encouraging high-quality compliance with the FSF's disclosure recommendations as well as promoting broader enhancements to disclosure practices in the future. Supervisors within FSB member jurisdictions have done this mainly by identifying and sharing leading disclosure practices and by addressing weak disclosure practices. For example:

- In Italy the banking, securities and insurance supervisors issued joint recommendations on enhancing financial disclosures. They have also encouraged the private sector to establish a body (which will include industry representatives, investors, auditors and supervisors) that will identify emerging issues related to securitisations and off-balance sheet activities and seek to enhance public disclosures in these areas. Certain other FSB member jurisdictions have established or specified public sector bodies to fulfil this on-going effort, particularly for major financial institutions. On-going dialogue about disclosure enhancement, which could clarify and improve relevance and decision-usefulness, is also evident between supervisors and audit firms and between supervisors and audit oversight bodies in some FSB jurisdictions.
- In the United States, the Securities and Exchange Commission is developing new regulations that will strengthen transparency requirements for public offerings, disclosure, and reporting for mortgage-backed and other asset-backed securities.
- The UK Financial Reporting Council published, in October 2008, *Louder than words: Principles for making corporate reports more relevant and less complex*, which identifies principles for both preparers and regulators that are designed to help reduce complexity and increase relevance in financial reporting.[16] In addition, the UK FSA published, in October 2009, *Enhancing financial reporting disclosures by UK credit institutions*, which stresses the importance of credit institutions providing high-quality disclosures, identifies the main areas where the UK FSA believes further improvements are both possible and desirable, and discusses ways of achieving that desired improvement.[17]

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[16] See http://www.frc.org.uk/press/pub1994.html.

[17] See http://www.fsa.gov.uk/pubs/discussion/dp09_05.pdf.

- Supervisors have also relied upon regional groups to evaluate disclosures, share information about strong practices, and identify areas for potential improvement. In particular, the Committee of European Banking Supervisors (CEBS) has issued several papers since June 2008 that assessed European financial institutions' disclosures during the financial crisis and promoted good practices disclosures.[18] CEBS capitalised on these observations, and in 2010 issued a set of principles for disclosures in times of stress which were intended to contribute to further improvements in the quality of disclosures in terms of substance, presentation and internal consistency for financial institutions placed in situations of stress.[19]

2.3 Initiatives of standard setters and others

In addition to the aforementioned efforts of supervisors and regulators, a number of other bodies have been actively fostering enhanced disclosures about structured credit products.

As mentioned earlier, the BCBS released enhanced Pillar 3 disclosure requirements in July 2009. Those enhanced requirements incorporate to a very large extent the FSF's recommended risk disclosures. (See Section 4 for a discussion of the implementation of the enhanced requirements and Annex 3 for a summary comparison of the FSF's recommended risk disclosures with the Pillar 3 enhancements and the IFRS disclosure requirements.)

In April 2010, the Technical Committee of International Organization of Securities Commissions (IOSCO) published a final report *Disclosure Principles for Public Offerings and Listings of Asset Backed Securities* ("ABS Principles") containing principles for use by securities regulators developing or reviewing their regulatory disclosure regimes for public offerings and listings of asset-backed securities.[20]

- IOSCO's ABS Principles provide guidance on the aspects of ABS transactions that need to be highlighted in the disclosures in order for investors to understand the transaction and the securities publicly offered or listed. To ensure that investors receive full and fair disclosure, the ABS Principles specify that information called for by specific disclosures may need to be expanded where supplemental information would be material to investors and necessary to keep the mandated disclosure from being misleading. The ABS Principles also require the disclosures to be presented clearly and concisely.
- Among the specific disclosure items addressed, the ABS Principles call for disclosure about the identity, functions and responsibilities of significant parties involved in the securitisation transaction; the structure of the transaction; risks; and the characteristics and performance of the pool assets. Such information is designed

[18] The results of CEBS's reviews can be found for 2007 at http://www.c-ebs.org/News--Communications/Archive/2008/CEBS-publishes-report-on-banks'-transparency-on-ac.aspx, for June 2008 at http://www.c-ebs.org/News--Communications/Archive/2008/CEBS-publishes-a-follow-up-report-on-banks-transp.aspx, for 2008 year-end at: http://www.c-ebs.org/News--Communications/Archive/2009/CEBS-has-published-today-two-reports-setting-out-t.aspx, and for 2009 year-end at http://www.c-ebs.org/News--Communications/Latest-news/CEBS-today-publishes-two-follow-up-reports-present.aspx.

[19] The document can be found at http://www.c-ebs.org/News--Communications/Latest-news/CEBS-today-publishes-its-Principles-for-disclosure.aspx.

[20] The IOSCO document is available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD318.pdf.

to provide investors with a context within which to analyse the ABS offered and the characteristics and quality of the asset pool.

Since the FSF's 2008 report was issued, accounting standards setters have significantly improved standards on crisis-related risk disclosures. For example:

(a) The IASB made changes to IFRS 7, *Financial Instruments: Disclosures*, in March 2009 that improved disclosures about fair value measurements, particularly those that use the most subjective inputs. The changes also introduced additional quantitative disclosures for derivative financial liabilities.[21] In addition, IFRS 7 was amended in October 2010 to improve disclosures about transfer transactions involving financial assets (for example, securitisations), including better information about any risks remaining after the transfer.

(b) The Financial Accounting Standards Board (FASB) has improved disclosure requirements about many of the areas mentioned in the April 2008 Report, such as securitisations, off-balance-sheet entities, credit exposures, and estimating fair values of financial instruments. The FASB's recent work on credit exposures has included enhanced information about credit risk, the rationale for the level and changes in credit loss estimates and troubled debt restructurings.

(c) As a part of efforts to address off-balance sheet risks or securitisation activities, the Accounting Standards Board of Japan published in March 2008 a revised *Accounting Standard for Financial Instruments* and *Guidance on Disclosures about Fair Value of Financial Instruments*.

Another important initiative concerns fast-track due processes. When the FSF issued its disclosure recommendations, the IASB did not have a fast-track due process procedure that would enable it to respond quickly to an urgent need for guidance or a new or revised standard. The IASB has since developed fast-track due process mechanisms that allow it, in cases of great urgency, to reduce its comment period to 30 days; thereby enabling it to react more quickly than hitherto.

In 2008, the FSF recommended that the IAASB, together with major national audit standard setters and relevant regulators, issue enhanced guidance on audits of valuations of complex and illiquid financial products and related disclosures. In response:

(a) In October 2008 the IAASB issued an Audit Practice Alert, *Auditing Fair Values Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*. The purpose of the alert was to highlight areas within the International Standards on Auditing (ISAs) that are particularly relevant in the audit of fair value accounting estimates in times of market uncertainty;[22]

[21] The required disclosures now include a three-level hierarchy for fair value measurements, with additional information for Level 3 valuations, which are the most subjective. In April 2010 the IASB amended IFRS 7 again by adding an explicit statement that the interaction between qualitative and quantitative disclosures better enables users to evaluate an entity's exposure to the variety of risks arising from financial instruments. The IASB amended IFRS 7 further in October 2010 to enhance the disclosure requirements about transfers of financial assets and in early 2011 it also enhanced the disclosure requirements about unconsolidated entities.

[22] See http://web.ifac.org/publications/international-auditing-and-assurance-standards-board/practice-alerts-and-q-as.

(b) In October 2010 the IAASB released for public comment a proposed new pronouncement to highlight practical considerations for auditors when dealing with complex financial instruments. The pronouncement emphasised auditing considerations relating to valuation and disclosure issues for financial statement items measured at fair value;[23]

(c) In January 2011, the IAASB released for public comment a discussion paper, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*, that explores key auditing issues related to disclosures in financial statements;[24] and

(d) In May 2010, the Japanese Institute of Certified Public Accountants, the self-disciplinary association for professional accountants in Japan, published guidance for *Audits of the Disclosure of Financial Instruments at Financial Institutions*.

The FSB also recognises that after the FSF April 2008 report was issued principles and recommendations that seek to enhance risk disclosure practices have been published by other organisations, including the Institute of International Finance,[25] the British Bankers Association,[26] and the International Corporate Governance Network.[27]

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23 See http://press.ifac.org/news/2010/10/iaasb-proposes-new-guidance-on-auditing-complex-financial-instruments.

24 See http://www.ifac.org/Guidance/EXD-Details.php?EDID=0154

25 See http://www.iif.com/press/press+releases+2008/press+75.php.

26 See http://www.bba.org.uk/policy/article/bba-adopts-new-disclosure-code/disclosure.

27 See http://www.icgn.org/best-practice/.

3. Response to FSF recommendations by financial institutions

3.1 Key findings and recommendation

- *Compliance with the FSF's 2008 recommended risk disclosures by financial institutions seems generally to have been good in most areas and as a result disclosures provided about structured credit risk exposures have generally been more comprehensive and more granular. However, the quality of public risk disclosures varies across institutions and jurisdictions and there remains room for improvement.*
    - *Several supervisors pointed to the need for further improvements in particular on the qualitative aspects of the risk disclosures since most disclosures were primarily quantitative in nature. Further improvements in the quality and focus of the narrative disclosures provided on securitisations and SPEs are needed.*
    - *In several cases, information about the off-balance sheet exposures of SPEs was difficult to assess because it was not disclosed in a comprehensive and consistent manner.*
    - *The FSF's 2008 risk disclosure recommendations placed particular emphasis on the need to provide information about risk exposures before and after hedging, and this was another area where practice in some cases fell short of the FSB's expectations.*
    - *Improvements could also be made in the level of detail and granularity of the sensitivity analysis of securitisation exposures measured at fair value.*
- *Most of the financial institutions using the Basel II capital framework within the review sample provided disclosures on structured credit risk exposures in Pillar 3 reports; others presented them in their financial reports.*
- *The audit assurance provided on risk disclosure varies depending on the location of publication: financial statements, management discussions and analyses in financial reports or Pillar 3 reports. This different treatment can be confusing for users of risk disclosures.*

In the light of the above finding the FSB recommends that:

Recommendation 1 *Financial institutions should adopt, and jurisdictions should encourage adoption of high-quality disclosure practices and thereby improve the consistency of risk disclosure. The FSB plans further work during 2011 to identify examples of leading practice disclosures based on consideration of recent annual report disclosures.*

Recommendation 2 *The IAASB should review whether there is a need for further guidance on the level of assurance provided by external auditors on risk disclosures, including those in the various sections of financial reports and public websites, and how that level of assurance is disclosed.*

3.2 Review of risk disclosures

All 24 FSB member jurisdictions reviewed the disclosures provided by their financial institutions in response to the FSF's risk disclosure recommendations and submitted the results of those reviews to the FSB.[28] Nine member jurisdictions indicated that at least some financial institutions in their jurisdiction had reported significant structured credit risk exposures in 2009. In other cases, member jurisdictions indicated that they either had not reviewed whether any reported exposures were significant, or had concluded they were not significant. On average, those banks, securities firms, and insurance companies that were reviewed represented about 60, 40, and 40 percent of their market shares within the reporting jurisdictions.[29]

FSB member jurisdictions used different approaches to selecting the number and type of financial institution to be reviewed based on a number of criteria including: market share of the financial institution, potential significance of exposures, and, in some jurisdictions, the desire to evaluate a variety of types and sizes of financial institutions. Therefore, the reviewed financial institutions varied greatly with respect to the extent of exposures as well as their global significance. Many of the institutions reviewed, while providing some of the recommended disclosures, did *not* have significant exposures to all (or any) of the five types of exposures mentioned in the FSF's 2008 Report.[30] Of the institutions reviewed by the FSB member jurisdictions, the number and breakdown of institutions that had made at least some of the FSF recommended disclosures were as follows (this includes member jurisdictions where many of the institutions reviewed did not have significant exposures):

[28] Generally, supervisors for banks, securities firms, and insurance firms worked together to provide one consolidated response per FSB member jurisdiction.

[29] Perceptions related to coverage of the average market share reviewed would be different if this evaluation was focused on mature/developed markets. For example, if only eight of the G-10 countries were considered, the average bank, securities firms, and insurance firms represented about 62, 67, and 27 percent of the respective market shares.

[30] Exposures to SPEs, other subprime and Alt-A exposures, CDOs, RMBS and leveraged finance.

Number of reviewed financial institutions making recommended risk disclosures[31]
(breakdown by jurisdiction and sector)

FSB member jurisdictions	Banks/credit institutions	Insurance Companies	Securities firms	Total
Australia	5			5
Canada	6			6
China	6			6
France	5			5
Germany	8			8
Italy	2			2
Netherlands	2			2
United Kingdom	5			5
Subtotal for EU Member States	*22*			*22*
Hong Kong SAR	2			2
Japan	3			3
Korea	3	3	2	8
Russia	19			19
Saudi Arabia	5			5
Singapore	3			3
Switzerland	2			2
United States	14	4	2	20
	90	7	4	101

Subsequently, the SCSI reviewed a number of these financial institutions' 2009 risk disclosures. The financial institutions involved were those that had securitised either their own assets or assets of third parties. This sample comprised mostly credit institutions and investment banks, although a few securities firms and financial conglomerates were included. The sample therefore did not include financial institutions that had significant exposures to structured credit products only because of their investments in such products, as might be the case for some insurance companies and pension funds.

The financial institutions in the FSB's sample had securitisation exposures because:

- some of the securitised assets were retained;
- SPEs used for securitisations did not meet the criteria for derecognition or consolidation and therefore remained on-balance sheet;
- they had acquired interests in securitisations originated by third parties;
- credit enhancements, liquidity support and/or other guarantees were provided to SPEs used for securitisations.

As a result, under the relevant financial reporting standards, financial institutions had on- or off-balance sheet exposures related to securitisation activities. In some cases, the FSB noted

[31] The table shows the number of financial institutions that were reviewed by the relevant FSB member jurisdiction and were found to have made at least some of the recommended disclosures.

that by the end of 2009 the total exposure of the types of off-balance sheet SPEs identified in the 2008 FSF report represented nearly 50% of the total owners' equity of the institution. The FSB also noted that only a few of the largest globally active institutions provide clear information about the aggregate maximum exposure to these types of off-balance sheet entities.

Location of the recommended disclosures provided

The location in which the FSF's recommended disclosures were presented varied. Although they were most commonly found in annual financial reports, the information was also disclosed in separate Pillar 3 disclosure reports, in other publicly available presentations and documents, and on publicly accessible websites.

Generally speaking, financial institutions in FSB member jurisdictions that had adopted Basel II standards incorporated the FSF recommended disclosures in their Pillar 3 disclosures; and financial institutions in jurisdictions that had not yet adopted Basel II tended to provide the risk disclosures in their annual financial reports, or in separate disclosure reports.[32] [33]

Additionally, in response to the FSF's recommendations and changes in accounting standards, nearly all bank and insurance supervisors in FSB member jurisdictions have modified their regulatory reporting requirements to include additional elements about securitisation, off-balance sheet activities, and subprime risk exposures. Consequently, much of the information required to comply with the FSF's risk disclosure recommendations is provided in regulatory reports, which are publicly available, individually or in aggregate, in some FSB member jurisdictions.

Are the risk disclosures audited or unaudited?

Risk disclosures provided in the annual financial statements (including the notes) tend to be audited by external auditors. On the other hand, risk disclosures provided in the management commentary or in the financial review sections of the annual report tended to be unaudited but subject to some form of review by the external auditors—although practice varies across jurisdictions. Risk disclosures published on a financial institution's website or in presentations provided to analysts and other users are unaudited. Furthermore, Pillar 3 risk disclosures are usually unaudited regardless of where they are provided.

Thus, users cannot assume that information provided in compliance with the FSF's risk disclosure recommendations has been subject to the same level of external assurance in all cases. In addition, the variety of practice makes misunderstandings about whether information is audited or unaudited more likely, which can create further difficulties for users.

In one FSB member jurisdiction (France) the securities regulator took specific action to encourage auditors to provide the same level of assurance for risk disclosures as for the annual financial statements.

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[32] As explained elsewhere in this report and summarised in annex 4, the Pillar 3 disclosure requirements have been enhanced to include nearly all of the FSF's recommended risk disclosures. After their effective date all relevant entities will provide the disclosures amongst their pillar 3 disclosures.

[33] This is not a strict distinction. In some countries that have already adopted Basel II (e.g. Germany) financial institutions also used annual reports and especially the separate disclosure reports.

In the United Kingdom, Principle 5 of British Bankers Association code requires banks to differentiate clearly in their annual reports between information that is audited and information that is unaudited. In a similar vein, a few financial institutions (eg, Morgan Stanley) have indicated in their financial reports for each element of the risk disclosure whether it was audited, reviewed by auditors, or not audited.

The IAASB has taken steps to enhance its auditing guidance related to complex instruments and their valuations (see Section 2.3) and the IAASB is aware that various jurisdictions have differing requirements on which aspects of the annual reports are audited. It is currently reviewing its standard on the auditors' responsibilities relating to other information in financial statements, and has also issued a discussion paper for public comment on auditor responsibilities and practices regarding disclosures.

3.3 Overall appraisal of risk disclosure practices in 2009

Based on the FSB review, risk disclosure practices in 2009 were in many respects in line with the FSF 2008 recommendations and were generally more comprehensive and more granular than similar disclosures in 2008. This finding is similar to the findings of the review work undertaken by CEBS and the Committee of European Securities Regulators (CESR).[34] Also, more of the information was provided in tabular formats than previously and this tended to improve readability, understandability and comparability.

The review identified some examples where a financial institution sought to achieve the objective underlying a FSF recommended risk disclosure by providing a disclosure that was different from the one the FSF had recommended. Where this has resulted in more meaningful information, it is to be commended.

Achieving the right balance between the detail and volume was also a challenge identified during the review. Transparency is often better served by clearer explanations than by more detailed numerical analysis.

Qualitative disclosures

FSB member jurisdictions generally require financial institutions to provide, in respect of their securitisation exposures and activities, meaningful, robust qualitative disclosures in addition to quantitative information. This is an area in which the quality of disclosure is variable and in need of improvement.

Financial institutions generally described accounting policies related to securitisations as part of their qualitative disclosures. These descriptions commonly included information about major accounting standards changes (i.e., affecting securitisation activities) that had occurred during reporting periods. Some financial institutions specifically addressed the consequences of the financial crisis on securitisation exposures, activities, and strategies.

Other qualitative information provided in the 2009 annual reports included descriptions of the nature of structured products, the volume of transactions and activities in SPEs, the financial institution's role in SPEs (eg. sponsor or investor), risk concentrations embedded within securitisation exposures and activities, the counterparty risk involved, and approaches to

[34] CESR assessed the application of Disclosure Requirements related to Financial Instruments in the 2009 Financial Statements of Financial Institutions. Website: http://www.cesr-eu.org/index.php?page=home_details&id=520.

assumptions and valuation methods (including impairment). However, the quality of these disclosures varied.

In some cases, annual reports also provided qualitative strategic information. For example, some financial institutions described the financial objectives or expected growth of various SPEs. Changes in strategies were also disclosed, such as decisions to disengage from certain SPEs or from certain types of securitisation activities.

An area in which disclosure was particularly poor was in the descriptions of the use and objectives of SPEs for securitisation activities. Generally speaking, the qualitative disclosures provided on this were insufficient.

Exposures before and after hedging

The FSF's 2008 risk disclosure recommendations placed particular emphasis on the need to provide information about significant risk exposures before and after hedging. Some institutions showed all structured credit exposures gross and net of credit protection, while other institutions provided information on monoline or credit protected securities separately at their fair value (taking into account the value of the derivative and any related credit valuation adjustment). In the FSB's view, a split between gross and net for all structured securities would be clearer and better for comparisons across institutions.

Other disclosures about securitisations

For those securitisation exposures that remain on balance sheet and are measured at fair value financial institutions did not always provide a meaningful and sufficiently detailed sensitivity analysis. Financial institutions in FSB member jurisdictions using accounting frameworks based on US GAAP or IFRS included disclosures about fair value estimates broken down into the three-level hierarchy and movements between the levels of the fair value hierarchy.[35] In several instances the information provided about valuation sensitivity, particularly for "Level 3" fair values (fair value determined without using observable inputs), was not sufficiently detailed to enable users to understand the impact of underlying management assumptions on the valuations.

Comparison of securitisation exposures is sometimes made more difficult by the use of different methodology and terminology. This was particularly challenging in cases where some of the information was provided in the financial statements (i.e. prepared on an accounting basis) and other in the Pillar 3 disclosures (i.e. prepared according to regulatory requirements). In such circumstances, the information would be more useful if users were able to navigate between the two sets of information more easily. Aligning the use and meaning of terminology as far as possible would lessen confusion for users of disclosures and perhaps also minimise the disclosure burden on banks.

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[35] Level 1 contains fair values for instruments with quoted market prices in active markets, Level 2 includes fair values based on observable market inputs for similar or related instruments, and Level 3 includes fair values based on unobservable, entity-specific inputs.

4. Pillar 3 disclosures and the implementation of enhanced Basel Pillar 3 disclosures

4.1 Key findings and recommendations

- *There is divergence in Pillar 3 practice with some institutions including their Pillar 3 disclosures in their annual reports and others publishing the disclosures in other ways (for example, in Pillar 3 reports published on their websites).*
- *The timing of the publication of the Pillar 3 disclosures is variable. Some institutions synchronise publication with the publication date of financial statements and annual reports, some publish the two sets of information at broadly similar times, and some publish the Pillar 3 disclosures a significant period after the annual report.*
- *There is generally little or no cross referencing between the Pillar 3 disclosures and the risk disclosures provided in the financial statements and annual report.*
- *Most FSB member jurisdictions are working to implement the enhanced Pillar 3 disclosure requirements by 31 December 2011 and, in some cases even sooner.*[36] *The FSB encourages its member jurisdictions to ensure that implementation timetables for the enhanced Pillar 3 disclosures will be met. The FSB urges those FSB member jurisdictions that have not yet developed an implementation plan to do so as soon as possible.*[37]

In the light of the above findings the FSB recommends that:

- ***Recommendation 3:*** *Banks and other credit institutions should improve the ways in which they make their Pillar 3 disclosure practices. In particular, they should:*
  - *ensure timely publication of their Pillar 3 disclosures, preferably aligned with the publication date of their financial reports; and*
  - *provide useful information to enable users to navigate between Pillar 3 disclosures and relevant disclosures in financial reports. This should include cross references between financial reports and Pillar 3 disclosures and information that aligns the relevant terminology and explains the differences in the bases for these disclosures (eg consolidation).*

4.2 Current Pillar 3 disclosure practices

Pillar 3 disclosures provide detailed qualitative and quantitative disclosures of, amongst other things, an institution's regulatory capital, its capital requirements related to credit risk, market risk, operational risk, interest rate risk and its securitisation exposures. In particular the

[36] The original implementation date was 31 December 2010. On 18 June 2010, the Basel Committee announced its decision to defer the implementation of the enhancements to the market risk framework by one year to no later than 31 December 2011. To avoid regulatory arbitrage, national supervisors are also permitted to postpone the implementation of the enhancements to the credit risk capital framework (released in July 2009) to coincide with the trading book reforms.

[37] The G20 Pittsburgh Summit Document states 'All major G-20 financial centers commit to have adopted the Basel II Framework by 2011' (Para.13). Therefore, FSB jurisdictions that are major financial centres are expected to adopt the Pillar 3 disclosures when they implement the Basel II framework by 2011 in line with the request from the G20.

revised Pillar 3 disclosures on securitisation exposures can contribute significantly to understanding the risk exposures and capital implications related to structured credit products.

The Pillar 3 requirements are relatively new and it will take a while for best practices to emerge. However, a number of issues are already emerging:

- Since Pillar 3 disclosures focus on the banking group, they can have a different scope of regulatory consolidation than the consolidated financial statements (eg. for a financial conglomerate). There are also other differences in the basis of preparation. These differences can make it difficult for users to relate information from the Pillar 3 disclosures to information from the annual report (and vice versa).
- There is currently divergence in practice as to how the Pillar 3 disclosures are published, with some institutions annexing their Pillar 3 disclosures to their annual reports, while other institutions are publishing the disclosures separately (for example, via presentations or other documents published in hard-copy or via their websites).
- If Pillar 3 information is presented as part of the annual report it would be checked for consistency (with other parts of the annual report) by the external auditor. However, if the information is presented separately a consistency check would not necessarily be carried out by the external auditor.
- There is considerable variability as to when the Pillar 3 disclosures are published. Some financial institutions publish them at the same time as their annual reports or soon after those reports are published, but other institutions publish them some time later—in some cases a very considerable time later. CEBS has previously raised the issue of the timeliness of Pillar 3 disclosures and some local industry associations have agreed best practices on the timeliness of Pillar 3 publications by financial institutions.

The FSB recommends that Pillar 3 disclosures should be published close to the publication date of the institution's annual report and, when provided on an interim basis, close to the publication date of the relevant interim financial reports. In addition, financial institutions should refer to their Pillar 3 disclosures in their annual reports and vice versa. Finally, the FSB recommends that financial institutions provide in their Pillar 3 disclosures summary information that assists users in understanding any differences in the basis used in the Pillar 3 disclosures compared to the basis used in the annual report (eg basis of consolidation).

Moreover, as noted in Section 3.3, comparison of securitisation exposures is sometimes made more difficult by the use of different methodology and terminology in the financial statements (i.e. prepared on an accounting basis) in comparison with the Pillar 3 disclosures (i.e. prepared according to regulatory requirements). In such circumstances, the information would be more useful if users were able to navigate between the two sets of information more easily. Aligning the use and meaning of terminology as far as possible would lessen confusion for users of disclosures and perhaps also minimise the disclosure burden on banks.

4.3 Implementing enhanced Pillar 3 disclosure requirements

As already explained, following the release of the FSF 2008 risk disclosure recommendations, the BCBS enhanced its Pillar 3 disclosure requirements in the following six areas:

(i) Securitisation exposures in the trading book;

(ii) Sponsorship of off-balance sheet vehicles;

(iii) Internal Assessment Approach and other ABCP liquidity facilities;

(iv) Re-securitisation exposures;

(v) Valuation with regard to securitisation exposures; and

(vi) Pipeline and warehousing risks with regard to securitisation exposures.

Nearly all FSB member jurisdictions (23 out of 24) have made progress towards implementation of the Pillar 3 enhancements.[38]

Most of those 23 jurisdictions are working towards the 31 December 2011 deadline, although India, Saudi Arabia and Switzerland intend to implement the enhancement by the original effective date of end-2010 (or 1 January 2011) or even earlier.

- The EU has adopted amendments to the Capital Requirement Directive (CRD), including the Pillar 3 enhancements, which transposes the BCBS capital requirements into EU legislation.[39]
- Australia, Canada, Hong Kong SAR, Indonesia, Korea, Japan, Mexico, Singapore and Switzerland are committed to implement the Pillar 3 enhancements from the end of 2011 or beginning of 2012.
- China required all commercial banks to adopt strict requirements about risk disclosure while permitting large, internationally active domestically-incorporated banks to comply with the requirements of the Pillar 3 enhancements.
- The United States banking agencies are developing rulemakings to implement the BCBS July 2009 enhancements to the Basel Accord.
- Russia is amending the legislation focused on the implementation of Basel II Pillar 3, including the enhancement of disclosure requirements.

Some FSB member jurisdictions (such as the EU, Russia and Hong Kong SAR) will introduce the enhancements through legislative amendments; most will implement the Pillar 3 enhancements through supervisory regulations and guidance.

For those jurisdictions committed to implementing the Pillar 3 enhancements, supervisory authorities have taken actions to communicate their expectations with respect to compliance with the enhanced disclosure requirements. These actions include holding bilateral meetings with banks, conducting industry consultation, and issuing letters advising implementation timetables.[40]

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[38] Argentina does not yet have definitive plans to implement the Pillar 3 enhancements.

[39] The text, including the Pillar 3 enhancements, was adopted on 24 November 2010 by the European Parliament and the European Council. The amendments came into effect at the beginning of 2011. Member States of the EU are required to incorporate the CRD III amendments into national capital and disclosure rules by 31 December 2011 at the latest. (EU Member States include the following FSB member jurisdictions: France, Germany, Italy, Netherlands, Spain and United Kingdom).

[40] In Germany, existent Pillar 3 templates are jointly being reviewed by supervisors and industry representatives to incorporate the amendments. Singapore has also updated its existing guidance templates in accordance with the enhanced requirements.

4.4 Entities to which the enhancements will be applied

While many FSB member jurisdictions will apply the Pillar 3 enhancements to all banks when relevant, some are planning not to mandate the disclosures for some or all of their smaller credit institutions. In particular:

- some FSB member jurisdictions (for example, China and the United States) will require only their large, internationally active domestically-incorporated banks to adopt the Pillar 3 enhancements or will exempt smaller domestic banks from the Pillar 3 disclosure requirements (eg. Hong Kong SAR, and Saudi Arabia); [41]
- domestic banks in Brazil, Saudi Arabia and Switzerland that have immaterial securitisation exposures are subject only to simplified or limited disclosure requirements. Banks using the standardised approach to calculate credit risk under Basel II will make less detailed disclosures compared to banks that use the Internal Ratings Based approach.

Generally the Pillar 3 enhancements will be applied at the consolidated group level.

[41] In Hong Kong SAR, de minimis exemptions exist for an authorised institution (AI) if the AI is a deposit-taking company or restricted licence bank; and its total assets less provisions is less than HK$1 billion; and it has total deposits from customers of less than HK$300 million. In the case of Saudi Arabia, the scope of implementation is restricted to all licensed commercial banks in accordance with Saudi Arabian Monetary Agency general guidelines concerning materiality threshold.

5. Initiatives needed to keep risk disclosures relevant and useful going forward

5.1 Key findings and recommendations

- *Very few FSB member jurisdictions reported significant joint interactions involving investors, financial institutions and auditors to help ensure that risk disclosure practices are kept up-to-date going forward, although the FSF recommended this in 2008.*
- *Based on FSB member responses, neither market pressure nor private sector initiatives seem sufficient to ensure that risk disclosure practice is kept up-to-date going forward. Some public sector involvement is also needed.*
- *International initiatives can complement national policy actions and thereby promote completeness in coverage of key risk exposures and improve the consistency of disclosures by financial institutions.*

In the light of the above key findings the FSB recommends that:

- ***Recommendation 4** The FSB should facilitate work by investors, industry representatives and auditors to take the 2008 FSF recommendations forward by encouraging them to develop principles for useful risk disclosures as market conditions and risk profiles change.[42] To initiate this process the FSB plans to organise during 2011 an international roundtable on risk disclosures that will bring together a broad spectrum of participants including standard setters, prudential authorities and market regulators, investors, accountants, auditors and economists.[43]*
- ***Recommendation 5** The FSB, drawing upon its members' expertise, should periodically evaluate emerging risks and vulnerabilities and make recommendations as needed to enhance sound risk disclosures by financial institutions. The FSB could build on its existing work to identify emerging risks and vulnerabilities by specifically considering whether there are areas where additional disclosures by financial institutions would help safeguard financial stability. Efforts involving international standard setting bodies and joint private sector initiatives will in many cases be the most appropriate manner to take those recommendations forward. The FSB should coordinate as necessary the alignment of the activities of standard setting bodies to fill any gaps arising because of a lack of a timely response or from financial stability concerns.*

5.2 Promoting further enhancements to risk disclosures

The risk disclosure recommendations the FSB made in 2008 reflected economic conditions at that time. Some of those recommendations remain relevant today, but some others probably

[42] This review report includes (in section 6 and Annex 5) some initial thoughts of the FSB on this subject.

[43] Should the planned roundtable not achieve sufficient progress in this area, the appropriate international standard-setting bodies will be asked to take forward work to consider principles..

do not. Furthermore, today's economic conditions might require risk disclosures not considered at the time of the 2008 report.

The FSF recognised this in its 2008 report and made recommendations designed to ensure there would be a framework to update risk disclosures as financial markets evolve. This section considers the progress made since the report in putting in place such a framework. In doing so, it looks in particular at the role that public sector initiatives should play in the process and in the relationship between national and international bodies.

The need for public sector initiatives on risk disclosure

In the past there has been much debate about the extent to which it is appropriate to rely on market discipline to achieve sound and timely risk disclosure. However, during the financial crisis it became clear that market discipline alone was not sufficient to achieve sound and timely risk disclosure by all major financial institutions. This is now widely accepted with only a few respondents to this thematic review arguing that reliance should be placed solely on market pressure to encourage compliance with sound disclosure principles.[44] Some form of intervention is needed to supplement market pressure.

One possibility is that this intervention could take the form of private sector initiatives. However, as is discussed more fully under the next heading, despite recommendations made by the FSF few FSB member jurisdictions report significant private sector initiatives over the last two years to move risk disclosure practices forward. This raises serious questions about whether private sector initiatives alone can be effective in improving and accelerating risk disclosure practices. Yet the FSB continues to believe that such initiatives are an essential part of a framework that will ensure that risk disclosures are updated as financial markets and risks evolve.

The FSB believes that public sector initiatives need to fulfil two roles.

- Firstly, public sector initiatives must be used where market pressure and private sector initiatives cannot provide the desired transparency outcomes in a timely manner, such as during periods of market turmoil. In such circumstances, public sector initiatives would encourage financial institutions to deliver promptly enhanced and timely risk disclosure practices, so that market participants can properly assess the risks most relevant for an entity or sector.
- Secondly, as the discussions under the next two headings illustrate, public sector initiatives are sometimes needed to encourage effective private sector initiatives in the risk disclosure area and to help in achieving internationally consistent approaches.

Dialogue between investors, financial industry and auditors to enhance risk disclosure principles

The 2008 FSF recommendations called upon private sector participants to work together to develop principles for useful risk disclosures and to meet on a semi-annual basis to discuss risk disclosures that would be most relevant based on then prevailing market conditions.

[44] Although some institutions clearly do benchmark their disclosures against other institutions as a way to respond to market pressure and benchmarking can lead to greater consistency of disclosure practices, benchmarking will not necessarily lead to disclosures that are timely and sufficient.

While standard setting bodies have improved their disclosure requirements, based on the information provided by the FSB member jurisdictions, private sector dialogues and joint efforts between different private sector actors have been extremely limited, or non-existent.

In some FSB member jurisdictions dialogue took place to address disclosure practices but not with all of private sector actors. For example, some members (France, China) noted that bilateral discussions had taken place between financial analysts and banks which had helped to improve the effectiveness of bank disclosures. In one member jurisdiction this led to enhanced disclosure of losses on real estate loans. In addition, in some cases private sector bodies (eg the Institute of International Finance) issued discussion papers and recommendations but not as a coordinated effort with other actors, such as investors and auditors.

In a number of jurisdictions (Australia, Brazil, Canada, China, France, Hong Kong SAR, Italy, Japan, Netherlands, Saudi Arabia, Spain, Switzerland, United Kingdom, United States) there is regular communication between supervisors, auditors, and financial industry representatives. Some respondents expressed concern that these dialogues are taking place solely at a national level, and should be co-ordinated internationally. Furthermore, these discussions did not involve joint dialogue with all key parties (eg investors).

In its 2008 Report the FSF concluded that joint private sector initiatives had an important role to play in improving risk disclosures. Despite the relative lack of such initiatives since then, the FSB believes these are essential if risk disclosures are to be kept up-to-date as financial conditions and risks evolve. Therefore, going forward, the FSB (Recommendation 4) intends to facilitate a dialogue between investors, financial institutions, auditors, supervisors and regulators and to:

- Promote the development of principles for leading practice risk disclosure and to update those principles as needed, based on changing conditions and risks; and
- Discuss specific disclosures to highlight leading practices based on current market conditions and emerging risks facing the financial system.

A more prescriptive approach by securities market regulators, prudential authorities or accounting standard setters may prove necessary if this approach proves inadequate.

The FSB plans to hold a roundtable in 2011 to explore how to further advance the dialogue between investors, financial institutions, auditors, standards setters, supervisors and regulators on the principles for leading practice risk disclosure and on highlighting leading practices.

Enhancing international comparisons and consistent treatments

The majority of FSB member jurisdictions believe that international initiatives are necessary in order to enhance international comparisons between jurisdictions, create a ‘level playing field’ (Canada, France, Hong Kong SAR, Italy, Switzerland, Singapore), and prevent ‘regulatory arbitrage’ (Turkey). However, some respondents note that national discretion is necessary given the different nature of various jurisdictions’ institutions and their exposures to different types of risk (Brazil). Others state that disclosure requirements should be set at the national level but take into account internationally co-ordinated guidance (Korea, Turkey, United States).

A number of individual regulators of FSB member jurisdictions (Brazil, United Kingdom, Korea, Italy) have implemented risk reporting disclosure frameworks since 2008 to improve disclosures. However, according to one public response these may have contributed to some lack of consistency and comparability across institutions in different jurisdictions. The actions of individual regulators in the past two years is understandable given the scale of the financial crisis and the significant attention paid to disclosures in annual reports during this period, but international coordination of disclosures guidelines could enhance comparability. One member jurisdiction (Netherlands) thought there is a risk in developing too many disclosure guidelines, and that this may be leading to excessive disclosure in annual reports. In its view, a simpler, more harmonised approach might prove more effective.

Some of the responses also noted that the regular communication between auditors, financial industry representatives and supervisors is taking place at national level. They suggested co-ordinating these dialogues at an international level through the FSB. The FSB agrees that *international* initiatives can complement national initiatives by promoting completeness in coverage of key risk exposures and encouraging consistent disclosure across financial institutions. The FSB is well placed to draw international attention to emerging risk disclosure issues, including those related to implementation, because of its international membership and its broad financial sector focus.

Template approaches to enhance disclosures

A few FSB member jurisdictions (France and Italy) established templates or forms in which the disclosures recommended in the 2008 FSF report were to be included in financial reports.

Proponents of a template approach argue that templates enhance the ability to make comparisons between financial institutions which could improve the insights of investors and other market participants into the relevant risk exposures and risk management practices of financial institutions. They also argue that the use of templates ensures that financial institutions will be compelled to make the disclosures. Indeed, according to one member jurisdiction that implemented such a system (France), the templates were well received by the financial analyst community (although analysts would have liked harmonisation at international level in the presentation of the risk exposures recommended by the FSF to facilitate comparisons between international banks).

On the other hand, others argue that a significant drawback of the template approach is the need for highly detailed definitions to ensure that what appears alike is in fact alike. Also, one of the public responses (an audit firm) criticised the template approach because the templates are, it claimed, often out of date by the time they are released and as a result do not reflect emerging risks.

One FSB member jurisdiction (United Kingdom) encouraged the development of a voluntary disclosure code that is adopted by its largest credit institutions. The supervisors in that jurisdiction have reviewed compliance against the code and discussed areas of non-compliance and examples of good disclosure practices with the financial institutions individually. This approach may provide more flexibility than the use of standard templates. On the other hand, voluntary codes lack enforceability. There is also the potential for inconsistencies in the quality of disclosure, although regular discussions between institutions, auditors and regulators concerning the quality of their disclosures and regulator-issued peer comparison reports can help to ensure that institutions applied the principles effectively and consistently.

FSB members should carefully consider how best to encourage improvements in risk disclosure practices. The sound use of templates could improve the comparability of information provided in risk disclosures, which could enhance the insights of investors and other market participants into the relevant risk exposures and risk management practices of financial institutions.

6. Initial considerations for possible risk disclosure principles and improvements to risk disclosures

6.1 Background

As explained in Section 5 of this paper, the risk disclosure recommendations the FSB made in 2008 reflected the market turmoil of early 2008. Thus, the recommendations were very much 'of their time' and they were designed as a short-term 'fix' (although many of the disclosures recommended remain relevant today). In the longer-term, the FSF's expectation was that joint private sector initiatives would develop risk disclosure principles that could be used by financial institutions to guide them in developing disclosures for identified risks that would meet the needs of users of published financial reports. The FSF also expected participants in that joint initiative would work together to identify emerging significant risks since the FSF's 2008 Report was published, and related enhancements to disclosure practices.

However, over the last two years there have not been significant private sector initiatives of the kind the FSB was expecting to see. In order to address this, the FSB is now trying to ensure that such initiatives take place and to facilitate the work involved (Recommendations 4 and 5).

Bearing in mind that two years have elapsed with relatively little done by the private sector to update the FSF's 2008 recommendations, the FSB believes it is important that this work now moves ahead. With that objective in mind, the FSB will be organising an international roundtable on risk disclosures that will be held in 2011 and for that purpose will bring together a broad spectrum of participants, including standard setters, prudential authorities and market regulators, investors, accountants, auditors and economists. The objectives of that roundtable will be:

- to encourage the start of the joint private sector work on developing principles that will help financial institutions to provide leading practice risk disclosures even when market conditions and risk profiles are changing; and
- to facilitate the first discussion of the joint private sector initiative on the key risks faced by the financial sector and on identifying the types of risk disclosures that would be most relevant and useful to investors and other stakeholders at that time.

To help initiate the discussion at that roundtable, the FSB will put forward some initial considerations on both subjects. An outline of those initial considerations as it stands currently is set out in the remainder of this section, with more detail in Annex 4, which can assist discussions at the roundtable.

Since the FSF's 2008 Report, it has become apparent that a particularly effective way of encouraging improvements in risk disclosure practice is to highlight examples of leading practice. The timetable for this thematic review has made it difficult to include up-to-date leading practice examples in this report, but the FSB plans to discuss during the roundtable how best to identify up-to-date examples of leading practice disclosures that will encourage enhancements in risk disclosure in the areas where improvement is most needed.

6.2 Possible elements of principles for leading practice risk disclosure

As already explained, some rapid progress needs to be made in developing principles for leading practice risk disclosure. With that in mind, this paper sets out (in this section and in Annex 4), initial considerations on the subject. They are included in this paper as potential input for the discussions that will follow, including the discussions at the upcoming international roundtable.

The CEBS *Principles for disclosures in times of stress: Lessons learnt from the financial crisis* (CEBS Disclosure Principles), issued in April 2010, contain other principles that could form a part of the "starting point" discussions.[45] While CEBS's paper was focused primarily on disclosures that would be particularly informative during times of financial stress, the general principles of informative disclosures seem relevant for all phases in the economic cycle. Those principles are:

- Financial institutions should provide timely and up to date information.
- Financial institutions should provide disclosures on areas of uncertainty.
- Financial institutions should provide comprehensive and meaningful information that fully describes their financial situation.
- Disclosures should allow comparisons over time and between institutions.
- Financial institutions should seek to early adopt new disclosure regulations.
- Financial institutions should specify whether and to what extent information has been reviewed or verified by external auditors.

These principles are sensible, but they are high-level and any international principles along these lines may need to be supplemented as final principles are developed. For example, more detailed principles could consider issues such as:

- **The level of risk disclosure**—including the proportionality of the disclosure to the significance and relative level of the risk and to the complexity of the business and valuation methodology.
- **Risk characteristics to be highlighted**—potentially including those that influence future cash flows and their volatility.
- **The level of disaggregation (or granularity) at which risk disclosures need to be provided**—It is important that sufficient detail be given to enable users to understand material risks. However, it is also true that excessive detail can inhibit clarity.
- **Balancing the need for comparability against other considerations**—As demonstrated by the recent financial crisis, comparability—presenting information in a way that enables users to discern and evaluate similarities in and differences between the nature of risk exposures over time and across different institutions—is important to users. Appropriate levels of disaggregation and thoughtful use of time series and tabular formats can be some ways to enhance comparability.

[45] See http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-Principles-for-disclosures-in-times-of-stress.aspx.

- **The appropriate use of qualitative disclosures**—Numerical disclosures alone will often not provide users with all the information they need; qualitative disclosures are also necessary. Indeed, this thematic review has highlighted the importance of improving the qualitative disclosures on, for example, SPEs. On the other hand, qualitative disclosures have to be carefully targeted if they are to be useful but not excessive.

These possible elements are further considered in Annex 4.

6.3 Initial views on disclosure areas needing further attention

Recommendation 6 *The FSB encourages investors, financial institutions, auditors and standard setters to work together to develop leading practice disclosures, including for the following risk exposures of current interest to markets: 1) concessional loan restructurings, 2) exposures to sovereign debt and to other financial institutions and 3) liquidity and funding positions.*

The recommendations in the FSF's 2008 Report were based on economic conditions at the time of the report. Since then, some of the risks that the recommendations focused on might have become less significant and new risks have emerged (or existing risks become more significant). As was explained earlier, the FSB believes that there should be a joint private sector initiative to keep the key risks faced by the financial sector under review and to identify the types of risk disclosures that would be most relevant and useful to investors and other stakeholders at that time. Furthermore, as previously discussed, the FSB will help initially facilitate this work. Action is now urgently needed to bring the analysis underlying the 2008 recommendations up-to-date and to identify the disclosures needed for newly emerging risk exposures.

In order to help in this process, the FSB's initial thinking on the subject is summarised below. This discussion focuses mainly on banks, although some or all of it might also be relevant for other financial institutions. These considerations will be discussed further during the roundtable on risk disclosures that the FSB plans to organise in 2011.

6.3.1 Renegotiated loans with concessional terms

A significant risk exposure that has emerged since the FSF 2008 report concerns renegotiated loans with concessional terms. The crisis has prompted financial institutions to determine the best collection strategy to maximise cash flows from their borrowers, particularly those experiencing financial difficulties. This might include a variety of forbearance arrangements such as principal or interest forgiveness and term extensions. The significance of these forbearance programmes for future earnings of the financial institution is important for users of financial information and needs to be effectively disclosed.[46] Additionally, it appears that disclosure practices regarding impairment of such loans, as well as the different types of 'forbearance', are divergent. Given the volume of loans that have been renegotiated with concessional terms, greater disclosure than hitherto might also be necessary in this area.

[46] The IASB has recently dropped the mandatory requirement for details of the total exposure of renegotiated loans from IFRS 7.

Against this background, issues for consideration in the development of leading disclosure practices could include:

- Volume of renegotiated loans with concessional terms;
- Type of 'forbearance' provided;
- Impairment treatment applied to renegotiated loans; and
- Loan-to-value (LTV) dispersion across renegotiated secured loans (granular disclosures on collateral valuation as opposed to average data);
- Methodology used to value any collateral held.

6.3.2 Sovereign debt and financial organisation exposures

During the financial crisis certain exposures, including sovereign exposures and exposures to other financial organisations that were previously viewed as low risk given historic default rates and losses became high risk exposures. The collapse of Lehman Brothers in 2008 and the 2010 European sovereign debt crisis of some EU Member States have shown that a significant amount of contagion risk may exist between individual financial organisations and between financial institutions and individual governments.

Bearing that in mind, the disclosures provided in the past about such exposures might need to be re-engineered and extended. Issues for consideration in the development of leading disclosure practices could include:

- A breakdown based on geography, creditworthiness and risk-weighted asset values of sovereign debt exposures and their accounting classification;
- A breakdown based on geography, creditworthiness and accounting classification of exposures to other financial institutions; and
- Exposures to financial organisations divided into distinct categories (i.e. insurance firms, financial conglomerates, banks, hedge funds, exchanges).

6.3.3 Liquidity and funding

Financial institutions should make adequate disclosures about their liquidity and funding positions. The FSB's initial view is that many of the disclosures that have been provided in the past might not provide users with the information they need to understand a financial institution's exposure to liquidity risks. A rethink may be needed.

In 2008 the BCBS issued *Principles for sound liquidity risk management and supervision* and in December 2010 it finalised the rules text for the implementation of the new liquidity measures (the Liquidity Coverage Ratio and the Net Stable Funding Ratio) as part of the Basel III framework.[47] These measures, once introduced, and other information used for risk management purposes, together with qualitative information about risk management practices, might provide a basis for more informative disclosures by financial institutions about their liquidity and funding positions. [48]

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[47] Principle 13 of the *Principles for sound liquidity risk management and supervision*: "A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position".

[48] The 2008 BCBS publication notes that 'examples of quantitative disclosures currently disclosed by some banks include information regarding the size and composition of the bank's liquidity cushion, as well as the values of key metrics that management monitors (including regulatory metrics that may exist in the bank's jurisdiction) and the limits placed on the values of those metrics'.

The FSB also supports the BCBS in developing informative Pillar 3 liquidity disclosures to complement the new global liquidity measures once they are introduced. Possible issues for consideration could be disclosures of time series of the new liquidity measures which might mitigate concerns that point-in-time balance sheet information on the liquidity position is sometimes not very meaningful or timely. A time series of deposit/loan ratios might also be effective in highlighting high risk funding practices.

Annex 1: Extract from FSF April 2008 Report on Enhancing Market and Institutional Resilience

Risk disclosures by market participants

Financial institutions should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II.

During the early stages of the market turmoil, public disclosures by financial institutions did not always make clear the risks associated with their on- and off-balance sheet exposures. The information disclosed about risk exposures was not sufficiently timely and useful to many investors and other market participants. A number of financial institutions and auditors worked together to improve risk disclosures for structured products and other exposures, for example in financial accounts and other disclosures for the second half and for year-end 2007. However, a lack of adequate and consistent disclosure of risk exposures and valuations continues to have a corrosive effect on confidence.

Near-term recommendations

III.1 The FSF strongly encourages financial institutions to make robust risk disclosures using the leading disclosure practices summarised in this report, at the time of their upcoming mid-year 2008 reports.

Financial institutions should draw from leading practices to ensure that they provide meaningful disclosures about their risk exposures, risk management and accounting policies that are most relevant in view of current market conditions. Some examples of leading practice risk disclosures in current market conditions have been set forth in a supervisory report on recent quantitative and qualitative disclosures by a sample of global banks and securities firms.[49,50] This analysis focused on public disclosures about exposures to instruments that the marketplace currently considers to be high-risk or involve more risk than previously thought. Each of the disclosures is presently made by at least one of the surveyed firms, though few of the firms come close to making all of the disclosures.

Enhanced disclosure by financial firms of more meaningful and consistent quantitative and qualitative information about risk exposures, valuations, off-balance sheet entities and related policies would be very useful in restoring market confidence. The FSF therefore strongly encourages financial institutions to make robust disclosures using these leading practice disclosures, at the time of their upcoming mid-year 2008 reports, for those activities where they have significant exposures. Some disclosures may not be relevant for firms that do not have significant exposure to the activity concerned.

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49 The Senior Supervisors Group analysed year-end 2007 disclosures by a sample of large internationally-oriented banks and securities firms, in its report, *Leading-Practice Disclosures for Selected Exposures*, April 2008. The disclosures reviewed were those publicly available as of 7 March 2008.

50 The term "leading" is used to mean most informative, both as regards quantity and quality of information (eg. the data enable market participants to assess the risks and returns of investments in or exposures to the firm; market participants can properly understand data that are disclosed). The proposed disclosures are intended to supplement rather than replace existing risk disclosures, including those required under Pillar 3 of Basel II. In this context, disclosure broadly includes not only information presented in public securities filings but also information presented in earnings press releases and accompanying presentation slides posted to the firms' internet websites. Indeed, in certain cases, supplemental material can provide market participants with more timely and focused information on risk exposures of current concern.

Leading practice disclosures for selected exposures

The table below highlights these disclosures, which are further elaborated in Annex B and are described and illustrated in the above-mentioned report. In addition to the information in the table, many of the firms first disclosed the following details for each and all of the categories:

- Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable).
- Exposure before and after hedging.
- Exposure before and after write-downs.

Additional specificity has been provided through varying combinations of the disclosures contained in the table:

Purpose Entities (SPEs) - General • Size of SPE vs firm's total exposure • Activities of SPE • Reason for consolidation (if applicable) • Nature of exposure (sponsor, liquidity and/or credit enhancement provider) • Collateral type • Geographic distribution of collateral • Average maturities of collateral • Credit ratings of underlying collateral **Other Subprime and Alt-A Exposure** • Whole loans, residential mortgage-backed securities (RMBSs), derivatives, other • Detail on credit quality (eg. credit rating, loan-to-value ratios, performance measures) • Breakdown of subprime mortgage exposure by vintage • Sensitivity of valuation to changes in key assumptions and inputs **Commercial Mortgage-Backed Securities** • Breakdown of collateral by industry • Breakdown of collateral by geography • Change in exposure from the prior period, including sales and write-downs	**Collateralised Debt Obligations** • Size of CDOs vs firm's total exposure • Breakdown of CDOs – type, tranche, rating, etc. • Breakdown of collateral by type • Breakdown of subprime mortgage exposure by vintage • Hedges, including exposures to monolines, other counterparties • Creditworthiness of hedge counterparties • Credit valuation adjustments for specific counterparties • Sensitivity of valuation to changes in key assumptions and inputs **Leveraged Finance** • Funded exposure and unfunded commitments • Change in exposure from prior period(s), including sales and write-downs • Distribution of exposure by industry • Distribution of exposure by geography

Medium-term recommendations

The above disclosures are designed to address the specific areas of market concern during the current turmoil. To achieve a similar outcome in the medium term, future risk disclosures should focus on similar underlying principles, although the particular areas for additional disclosures will depend on market conditions at the time. This will require firms to maintain appropriate internal firm-wide risk measurement systems to deliver meaningful and timely risk disclosures.

III.2 Going forward, investors, financial industry representatives and auditors should work together to provide risk disclosures that are most relevant to the market conditions at the time of the disclosure. To this end:

- Investors, industry representatives and auditors should develop principles that should form the basis for useful risk disclosures.
- Investors, industry representatives and auditors should meet together, on a semi-annual basis, to discuss the key risks faced by the financial sector and to identify the types of risk disclosures that would be most relevant and useful to investors at that time.

Regulators, supervisors and standard setters should be consulted with respect to the above efforts. A more prescriptive approach by securities market regulators, bank supervisors or accounting standard setters may prove necessary if this market-led approach proves inadequate.

III.3 The BCBS will issue by 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II for:

- Securitisation exposures, particularly exposures held in the trading book and related to re-securitisation;
- Sponsorship of off-balance sheet vehicles, to give the market greater insight into the extent of banks' contractual and non-contractual obligations and exposures;
- Banks' liquidity commitments to ABCP conduits, to ensure that disclosure is as clear as for on-balance sheet credit exposures; and
- Valuations, including the methodologies and uncertainties related to those valuations.

Enhanced disclosures in these areas could help to avoid a recurrence of market uncertainties about the strength of banks' balance sheets in the event of a future episode of market turmoil. This strengthened guidance will be based on the lessons from the recent turmoil, including the leading practice disclosures recommended for the near term as noted above, together with an early assessment of the implementation of Basel II. The first Pillar 3 disclosures in many countries will be available by 2009.

Annex 2: FSB Risk Disclosure Review Template

28 June 2010

Thematic Review on Risk Disclosures by Market Participants

The financial crisis highlighted the importance to market confidence of reliable valuations and useful disclosures of the risks associated with structured credit products and off-balance sheet entities. In April 2008, the FSF recommended that financial institutions should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II. This template is a guide for member jurisdictions to provide input for the thematic review on the implementation of the risk disclosure recommendations of the April 2008 FSF Report on Enhancing Market and Institutional Resilience (http://www.financialstabilityboard.org/publications/r_0804.pdf). The template is structured around the three recommendations:

- *Part 1, on recommendation III.1 of the April 2008 Report, asks about supervisory dialogue with relevant firms about leading-practice risk disclosures to the public and the extent to which these firms made the identified disclosures in 2008 and subsequent periods.*
- *Part 2, on recommendation III.2, asks about industry efforts to identify the principles for useful risk disclosures, or to identify any specific additional recommended disclosures, going forward.*
- *Part 3, on recommendation III.3, asks about steps taken or planned by supervisors to implement by end-2010 the Basel II Pillar 3 disclosure enhancements set forth by the Basel Committee on Banking Supervision (BCBS) in July 2009.*

The template is intended to be completed by supervisory authorities for financial institutions that have significant exposures in the relevant areas. If there are any questions relating to the completion of the template please contact Gerald Edwards (gerald.edwards@bis.org; tel. +41 61 280 8055).

Member jurisdictions are kindly requested to return the completed template to the FSB Secretariat (gerald.edwards@bis.org; fsb@bis.org) by Wednesday, 25 August 2010.

Disclosures for crisis-related risk exposures

> ***III.1*** *The FSF strongly encourages financial institutions to make robust risk disclosures using the leading disclosure practices summarised in this report, at the time of their upcoming mid-year 2008 reports.*

FSF recommendation III.1 drew from the April 2008 report of the Senior Supervisors Group (SSG) to the FSF on *Leading-Practice Disclosures for Selected Exposures* (http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf), which included examples of public disclosures addressed in recommendation III.1. Members may find these examples helpful as they review their firms' risk disclosures.

1.1 Please describe the steps taken by supervisors or regulators in your jurisdiction to encourage public disclosures of the risk exposures identified in recommendation III.1. These risks were related to the crisis conditions in 2008 and included special-purpose entities, collateralised debt obligations, other subprime and Alt-A exposures, commercial mortgage-backed securities, and leveraged finance (see annex A).

1.2 What types of financial institutions in your jurisdiction were encouraged to make these disclosures (eg major financial institutions, locally incorporated financial institutions, or internationally active banks and securities firms)? Was this disclosure expected to be on a consolidated basis?

1.3 Please describe the steps taken by supervisors or regulators in your jurisdiction to assess the adequacy of disclosures of the risk exposures identified in recommendation III.1.

1.4 Financial institutions with "significant" exposures to the identified risks were expected to provide the disclosures. When the recommendations were agreed in 2008, the concept of significant exposure was flexible so as to allow supervisors, regulators, investors and market participants to consider significance in the context of their local markets. What are the process and criteria applied by supervisors or regulators in your jurisdiction to determine whether a firm's exposure to the identified risks is significant enough to warrant the expectation of disclosure? For example, are quantitative criteria applied for the size of the exposures in absolute terms, or in relation to total assets or capital?

1.5 Using the table below, please indicate for each period how many financial institutions located in your jurisdiction had significant exposures to the risks identified in recommendation III.1 and were, therefore, expected to provide the disclosures. Also please indicate their approximate market share in the table below (in terms of the institutions' total assets as a percentage of the sector's total assets).

	end-2008	end-2009
Number of financial institutions with significant exposures to the identified risks: total		
of which: banks		
securities firms		
other financial institutions		
Market share of the institutions above:		
banks		
securities firms		
other financial institutions		

1.6 Using the table in Annex A, please list for each period the number of institutions in your jurisdiction that provided the disclosures for each of the identified risks. Please specify in Annex B the names of these institutions and the approximate market share that they represent (in terms of the institution's total assets as a percentage of the sector's total assets in your jurisdiction).

Please only include in Annexes A and B information relating to firms that were deemed to have significant exposures to the risks identified in recommendation III.1. This will enable a comparison to be made between the number of firms expected to make disclosures (question 1.5 above) and the number that did in fact make the disclosures.

Firms that did not have significant exposures but disclosed these exposures anyway should not be included in the Annexes (or if included should be separately identified).

If these disclosures were not presented on a fully consolidated firm-wide basis, please mention the approach used.

If there are cases where firms have made disclosures covering only part of the template, please indicate whether this is because the parts not disclosed concerned areas where the firm did not have significant exposures.

1.7 The above disclosures are primarily quantitative in nature. Please discuss the extent to which qualitative information was also disclosed to provide context and relevant background information about the above quantitative disclosures.

1.8 Please specify whether the presented information was measured at fair value or amortised cost, and, if available, whether the fair values were level 1, 2 or 3.[51]

1.9 Please specify how the relevant disclosures were typically provided (eg as part of disclosures in published financial reports, investor presentations, website disclosures or other means). As mentioned in the FSF report, "In this context, disclosure broadly includes not only information presented in public securities filings but also information presented in earnings press releases and accompanying presentation slides posted to the firms' internet websites."

1.10 Please provide, for each of the institutions identified in Annex B, copies of the quantitative and qualitative information concerning the risk exposures identified in recommendation III.1 that they provided in their year-end 2009 disclosures.

1.11 Please describe any steps taken by supervisors to bring to firms' attention shortfalls in disclosure in the relevant areas. Also, mention whether there were discussions with audit firms regarding the adequacy of the risk disclosures identified in recommendation III.1.

Risk disclosures going forward

III.2 *Going forward, investors, financial industry representatives and auditors should work together to provide risk disclosures that are most relevant to the market conditions at the time of the disclosure. To this end:*

- *Investors, industry representatives and auditors should develop principles that should form the basis for useful risk disclosures.*
- *Investors, industry representatives and auditors should meet together, on a semi-annual basis, to discuss the key risks faced by the financial sector and to identify the types of risk disclosures that would be most relevant and useful to investors at that time.*

[51] In some jurisdictions, institutions may have provided information regarding the amount of the exposures that were reported using fair value measurement (either fair value through profit and loss, or fair value through other comprehensive income) or amortised cost. To the extent certain exposures were reported at fair value, some may also have indicated whether the fair values were categorised as level 1, 2 or 3 under standards of the IASB or US FASB.

Recommendation III.2 was designed to encourage private sector dialogue and was not directed to FSB members. Therefore, to help answer the following questions members may find it useful to inquire of associations representing investors, financial institutions, and auditors in their jurisdiction.

2.1 What progress have investors, financial industry representatives and auditors in your jurisdiction made in developing principles that provide a basis for useful risk disclosures?

2.2 Do investors, financial industry representatives and auditors in your jurisdiction regularly meet to identify on an ongoing basis the types of risk disclosures that would be most relevant and useful to investors? If so, please provide details.

2.3 What additional disclosures have firms in your jurisdiction made, beyond those described as leading practices in 2008, that could be suitable for inclusion in the leading practices going forward?

2.4 What is the best way to move forward this recommendation? Is market pressure sufficient or is official pressure needed? If additional official pressure were to be applied, should it be done at a national or international level?

Disclosures under Pillar 3 of Basel II[52]

III.3 *The BCBS will issue by 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II for:*

- *securitisation exposures, particularly exposures held in the trading book and related to re-securitisation;*
- *sponsorship of off-balance sheet vehicles, to give the market greater insight into the extent of banks' contractual and non-contractual obligations and exposures;*
- *banks' liquidity commitments to ABCP conduits, to ensure that disclosure is as clear as for on-balance sheet credit exposures; and*
- *valuations, including the methodologies and uncertainties related to those valuations.*

3.1 Which financial institutions in your jurisdiction will be required to implement the enhancements to Pillar 3 of Basel II, as set forth by the BCBS in its July 2009 report? For example, internationally active banks, all banks, or financial institutions with significant exposures? For jurisdictions where Pillar 3 has not been implemented, please summarise the extent of voluntary implementation of the enhanced disclosures.

3.2 Please summarise in the table on the next page the steps taken to implement the enhancements to Pillar 3 of Basel II. The BCBS specified that improved disclosures should be made in each of the areas listed in the table, as of 31 December 2010.

[52] This section of the questionnaire focuses on the enhanced Pillar 3 disclosures that directly related to recommendation III.3. The BCBS also set forth other enhancements to Pillar 3 disclosures that address areas that were not the focus of this recommendation.

Please also summarise any further actions planned during 2010 and any initiatives by firms in your jurisdiction to date to implement these disclosures.

(i) Securitisation exposures in the trading book	
Steps taken to date	
Actions planned, including timetable	
Evidence of firms' progress	
(ii) Sponsorship of off-balance sheet vehicles	
Steps taken to date	
Actions planned, including timetable	
Evidence of firms' progress	
(iii) Internal Assessment Approach and other ABCP liquidity facilities	
Steps taken to date	
Actions planned, including timetable	
Evidence of firms' progress	
(iv) Resecuritisation exposures	
Steps taken to date	
Actions planned, including timetable	
Evidence of firms' progress	
(v) Valuation with regard to securitisation exposures	
Steps taken to date	
Actions planned, including timetable	
Evidence of firms' progress	
(vi) Pipeline and warehousing risks with regard to securitisation exposures	
Steps taken to date	
Actions planned, including timetable	
Evidence of firms' progress	

Annex A
(of Annex 2)

Table on leading practice disclosures for selected exposures

Please list, for each period, the number of firms in your jurisdiction that provided disclosures for each of the identified risk exposures. Include only information relating to firms that were deemed to have significant exposures to the risks identified in recommendation III.1. Please list in Annex B the names of the firms that provided these disclosures. Members may find the examples in the SSG report useful as they review their firms' risk disclosures.

	Number of financial institutions providing disclosures	
	end-2008	**end-2009**
Special Purpose Entities (SPEs) - General		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)		
Exposure before and after hedging		
Exposure before and after write-downs[53]		
Size of SPE vs firm's total exposure		
Activities of SPE		
Reason for consolidation (if applicable)		
Nature of exposure (sponsor, liquidity and/or credit enhancement provider)		
Collateral type		
Geographic distribution of collateral		
Average maturities of collateral		
Credit ratings of underlying collateral		
Collateralised Debt Obligations		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)		
Exposure before and after hedging		
Exposure before and after write-downs		
Size of CDOs vs firm's total exposure		
Breakdown of CDOs – type, tranche, rating, etc.		
Breakdown of collateral by type		

[53] The FSF and SSG reports did not define the term "write-downs", but the SSG report provided examples of how major financial firms were disclosing write-downs. In principle, write-downs indicate how firms have reduced their risk exposures of the types identified in recommendation III.1, for example, through negative fair value changes and/or through reducing certain loans in response to credit loss impairments (such as through loan charge-offs).

	Number of financial institutions providing disclosures	
	end-2008	end-2009
Breakdown of subprime mortgage exposure by vintage		
Hedges, including exposures to monolines, other counterparties		
Creditworthiness of hedge counterparties		
Credit valuation adjustments for specific counterparties		
Sensitivity of valuation to changes in key assumptions and inputs		
Other Subprime and Alt-A Exposure		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)		
Exposure before and after hedging		
Exposure before and after write-downs		
Whole loans, residential mortgage-backed securities (RMBSs), derivatives, other		
Detail on credit quality (eg. credit rating, loan-to-value ratios, performance measures)		
Breakdown of subprime mortgage exposure by vintage		
Sensitivity of valuation to changes in key assumptions and inputs		
Commercial Mortgage-Backed Securities		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)		
Exposure before and after hedging		
Exposure before and after write-downs		
Breakdown of collateral by industry		
Breakdown of collateral by geography		
Change in exposure from the prior period, including sales and write-downs		
Leveraged Finance		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)		
Exposure before and after hedging		
Exposure before and after write-downs		
Funded exposure and unfunded commitments		
Change in exposure from prior period(s), including sales and write-downs		
Distribution of exposure by industry		
Distribution of exposure by geography		

Annex B
(of Annex 2)

Table on market share of firms providing the referenced disclosures

Please specify the name and market share of the financial institutions covered in the table in Annex A. Market share refers to the institution's total assets as a percentage of the sector's total assets and can be approximate. The purpose of collecting market share data is to facilitate analysis of possible gaps in coverage and identify whether disclosures are concentrated among the largest institutions.

	Market share	
Names of financial firms providing disclosures	**end-2008**	**end-2009**

Annex 3: A comparison of FSF 2008 recommended disclosures to relevant Pillar 3 enhancements and IFRS disclosure requirements

As noted in Section 4, the Pillar 3 enhanced requirements incorporate to a very large extent the FSF's recommended risk disclosures. This table provides a summary comparison of the FSF's 2008 recommended risk disclosures with the enhanced Pillar 3 requirements and IFRS disclosure requirements. The checkmarks below indicate that FSF recommended disclosures are captured by Pillar 3 or IFRS disclosure requirements.

FSF 2008 Recommended Disclosures	Pillar 3 Enhancements	IFRS[54]
Special Purpose Entities (SPEs) - General		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)	✓	IFRS 12 Forthcoming[55]
Exposure before and after hedging	✓	
Exposure before and after write-downs	✓	
Size of SPE vs firm's total exposure	Size of SPE but not vs firm's total exposure	
Activities of SPE	✓	
Reason for consolidation (if applicable)		
Nature of exposure (sponsor, liquidity and/or credit enhancement provider)	✓	
Collateral type	✓	
Geographic distribution of collateral	✓	
Average maturities of collateral		
Credit ratings of underlying collateral	✓	
Collateralised Debt Obligations		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)	✓	IFRS 7[56]
Exposure before and after hedging	✓	
Exposure before and after write-downs	✓	
Size of CDOs vs firm's total exposure	Size of securitisation	

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54 The IFRS disclosure requirements are objectives based. Accordingly, they do not prescribe the disclosures that must be made in all cases. Although the relevant IFRSs prescribe some specific disclosure items the most common approach is to identify and specify the information that is likely to meet a particular objective such as enabling users to evaluate the nature and extent of risks arising from financial instruments (IFRS 7). This approach means that the IFRS requirements do not necessarily map directly to the FSF 2008 recommendations. Separate footnotes to the headings in the IFRS column summarise the nature of the IFRS requirements which, in many cases, will lead to the same, or similar, information being disclosed in financial statements.

55 IFRS 12, *Disclosure of Interests in Other Entities*, is expected to be issued by the IASB in April 2011, and becomes mandatory on 1 January 2013. The new IFRS requires an entity to disclose information that enables users to understand the nature and extent of its interests in, and the risks associated with, structured entities (special purpose entities). In identifying the type of information that would meet the objective, IFRS 12 makes specific reference to maximum exposure to loss; nature, purpose and size of the activities; reason or not for consolidating the structured entity; the nature of the financial support including liquidity arrangements, guarantees, other commitments or credit rating triggers; losses incurred; ranking and potential losses borne by parties ranked lower than the reporting entity; and the forms of funding (including maturity analyses).

FSF 2008 Recommended Disclosures	Pillar 3 Enhancements	IFRS[54]
	exposures but not vs firm's total exposure	
Breakdown of CDOs – type, tranche, rating, etc.	✓	
Breakdown of collateral by type	✓	
Breakdown of subprime mortgage exposure by vintage		
Hedges, including exposures to monolines, other counterparties	✓	
Creditworthiness of hedge counterparties	✓	
Credit valuation adjustments for specific counterparties		
Sensitivity of valuation to changes in key assumptions and inputs		
Other Subprime and Alt-A Exposure		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)	✓	IFRS 7[56]
Exposure before and after hedging	✓	
Exposure before and after write-downs	✓	
Whole loans, residential mortgage-backed securities (RMBSs), derivatives, other	✓	
Detail on credit quality (eg. credit rating, loan-to-value ratios, performance measures)	✓	
Breakdown of subprime mortgage exposure by vintage		
Sensitivity of valuation to changes in key assumptions and inputs	BCBS supervisory guidance[57]	
Commercial Mortgage-Backed Securities		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)	✓	IFRS 7[56]
Exposure before and after hedging	✓	
Exposure before and after write-downs	✓	
Breakdown of collateral by industry	✓	
Breakdown of collateral by geography	✓	
Change in exposure from the prior period, including sales and write-downs	✓	

[56] IFRS 7, *Financial Instruments: Disclosures*, requires disclosure of the significance and effects of financial instruments on an entity's financial position and financial performance and the nature and extent of risks to which an entity is exposed from financial instruments and how those risks are managed. This means that an entity is required to provide information about risks that are relevant to an understanding of an entity's performance and would therefore result in the disclosure of information about material risks. In particular, qualitative and quantitative disclosures are required about credit risk, liquidity risk and market risk exposures. In identifying the type of information that would meet the objective, IFRS 7 and the associated implementation guidance makes specific reference to descriptions of concentrations of risk; maximum exposure to credit risk; counterparty credit risk; hedging (and designated derivatives) that mitigate risk; collateral, fair value measures; changes in fair value; sensitivity of valuations; and sensitivity of the financial statement measures. IFRS 7 does not specify the classes of assets (such as CDOs or leveraged finance) for which these disclosures should be provided. Information about a particular class of assets will be required if that class of assets is material to the reporting entity.

[57] The BCBS' *Supervisory guidance for assessing banks' financial instrument fair value practices*, April 2009, encourages disclosure of this type of information about sensitivities.

FSF 2008 Recommended Disclosures	Pillar 3 Enhancements	IFRS[54]
Leveraged Finance		
Total exposure, including on- and off-balance sheet analysis (as well as funded and committed lines, if applicable)	✓	IFRS 7[56]
Exposure before and after hedging	✓	
Exposure before and after write-downs[58]	✓	
Funded exposure and unfunded commitments	✓	
Change in exposure from prior period(s), including sales and write-downs	✓	
Distribution of exposure by industry	✓	
Distribution of exposure by geography	✓	

[58] The FSF and SSG reports did not define the term "write-downs", but the SSG report provided examples of how major financial firms were disclosing write-downs. In principle, write-downs indicate how firms have reduced their risk exposures of the types identified in recommendation III.1, for example, through negative fair value changes and/or through reducing certain loans in response to credit loss impairments (such as through loan charge-offs).

Annex 4: Initial views on themes for leading practice risk disclosures

Introduction

This annex (and section 6.2), sets out some initial thinking on themes to be considered for leading practice risk disclosures. It is included in this report to provide potential input for the detailed discussions on the subject that will follow in due course through a joint private sector initiative of investors, industry representatives and auditors.

Potential primary elements for robust risk disclosures[59]

The following 'primary elements' could be considered as part of the basis for enhanced disclosure principles:

1. **The level of risk disclosure should be proportionate to the significance and relative level of the risk and to the complexity of the business and valuation methodology and that assessment needs to be regularly updated**. Regular updating appears to be necessary because, during the recent financial crisis, apparent modest risks seemed to become high risks overnight as market liquidity evaporated and investor confidence diminished with the intensification of the financial turmoil.
2. **The degree of sensitivity of the balance sheet value of assets to the main drivers of that value (whether assumptions or risks) should be disclosed**. This information would enable users to understand the vulnerability of the underlying valuation.
3. **The key risk characteristics —that influence the likely future path and volatility of the cash flows associated with on- and off-balance sheet exposures— should be disclosed.** Such information might enable users to project future expected losses and the volatility of future cash flows on an institutions portfolio.

Practical implementation issues that could be reflected in high level disclosure principles

1) How to determine significance and the relative level of risk

Significance

If a notion of proportionality of the kind described above is to be used, it will probably be necessary to develop some material on determining the significance of a risk exposure. 'Significance' in this context will not necessarily be the same as an external auditor's notion of 'materiality' and might involve considering:

- whether the aggregate of the exposures with *similar risk characteristics* are significant?
- against what basis is significance determined? For example, a proportion of the institution's actual or required regulatory capital (eg. core tier one capital for banks) may be appropriate. Other commonly suggested measures include percentages of the balance sheet total assets or normalised profits.
- how is the significance of off-balance sheet exposures captured? Should the underlying asset pool of unconsolidated SPEs be considered?[60]

[59] As previously noted, more general principles, such as those set forth in the CEBS disclosure principles, may also be relevant in considering this topic.

Relative level of risk

Similarly, if a notion of proportionality based on relative levels of risk is used, consideration should be given to develop further the idea of 'relative risk levels'. Relative levels of risk could recognise that:

- Some risk exposures are more likely to occur than others and, when that is the case, more disclosure should be provided on risks that are more likely to be realized.
- An institution with a significant percentage of 'Level 3' fair value exposures (i.e. values based on unobservable inputs) should disclose considerably more on sensitivities than institutions that hold primarily 'Level 1' fair value exposures.

Affirmative statements/Confirming information

In developing leading practice risk disclosure principles, the possible role of affirmative statements/confirming information in financial reports should be considered. For example, when financial institutions do not have exposures of particular concern at a point in time, it may be beneficial to disclose this lack of exposure because such a disclosure may help reduce the uncertainty that might otherwise arise. A number of precedents for doing this already exist, including:

- Affirmative statements that the institution has not bought-back any loans of a certain securitisation type;
- Affirmative statements that a specific type of securitisation activity will not affect liquidity or capital of the institution;
- Affirmative statements that the institution has ceased a specific type of lending activity for the purpose of securitising those loans; and
- Affirmative statements that off–balance sheet exposures, such as guarantees and written CDS, are not material.

Before principles about affirmative statements would be adopted by standard setting bodies, the benefits of these statements must be weighed against the need for disclosures to avoid misunderstandings and misstatements.

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[60] The IASB's new consolidation standard (due to be issued in 2011) will include a new comprehensive disclosure standard, which is likely to cover disclosures for unconsolidated SPEs. The staff draft of the tentative decisions to date is shown here: www.ifrs.org/Current+Projects/IASB+Projects/Consolidation/Consol+disclosure/Staff+draft/staff+draft.htm.

2) Aggregation and Granularity

Balance

When developing principles for risk disclosures, it is important to strike an appropriate balance between aggregation and disaggregation (granularity) of disclosures. A key consideration in deciding the level of granularity could be to group exposures with similar risk characteristics. (Such a concept would be similar to the decision process discussed earlier for deciding whether exposures are significant.)

Any principle in this area could indicate that financial institutions should provide sufficiently granular information to provide a clear understanding of the risk exposure and should accurately portray the magnitude and risk characteristics of exposures with similar risk characteristics.

There may be circumstances where greater granularity may mask clarity or conceal key points, so this is another issue that needs to be balanced carefully.

In this respect the FSB has observed a variety of disclosure practices in this area.

> *Different Practices*
>
> Examples of differences in the granularity across institutions are:
>
> - Some credit institutions displayed the fair value hierarchy for exposures at a very granular level (eg. Alt A securities) while some institutions displayed fair value information at an asset class level (eg. asset backed securities).
> - Some credit institutions showed sensitivity in fair value measurement for the whole group of assets measured at 'Level 3, while other institutions provided more granular detail.
> - Some credit institutions showed geographical and industry breakdowns at an aggregate level (eg. total loans and advances to customers) whereas other credit institutions produced this breakdown at a more granular level (eg. for the commercial loan portfolio). Typically it is only those exposure types identified in the 2008 FSF report that were broken down at a granular level.
> - Some credit institutions disclosed a break-down of assets and risk-weighted assets by business line, or a break-down of risk-weighted assets by the standardised approach versus internal model approach.

Aggregation

Disclosures and breakdowns of risk at an aggregate level can help users to have an understanding of the full concentration of risk.

The financial crisis showed that some institutions may not have properly aggregated risks to counterparties across the institution (eg banking and trading book relationships and derivative positions). Appropriate levels of aggregated risk exposure disclosure could be beneficial so that the granularity of the other disclosures does not prevent the reader from seeing the "big picture". Leading practice risk disclosure principles in this area could help financial institutions to determine the most meaningful level of aggregation.

3) Comparability

Between entities

Comparability of financial information promotes a better assessment of the magnitude of risks in a financial institution when compared to its peers. The importance of such comparisons was demonstrated during the financial crisis where the 'outliers' were identified, highlighted and to some extent targeted by the market.

Any principles developed in this area could usefully distinguish comparability from uniformity; institutions are different and good disclosure practice enables users to understand and take into account those differences.

Comparability sometimes involves greater granularity, which raises the issue mentioned earlier of striking a suitable balance between disaggregation and lengthy disclosures.

Over time

The ability to conduct a comparison over time for an individual entity is important to understand the trend in risk exposures. This suggests that time series can often be helpful for users, particularly if volatile measures are involved.

Graphical presentations or tabular formats that combine several key attributes

Graphics or tabular formats can be a clear and effective way of explaining developments and related risks. These formats can be helpful also to understand trends over time and make comparisons between entities.

Some examples of tabular disclosures on structured credit products that may have provided users with helpful insights and could support comparability include:[61]

- Exposures by type, grouped by:
  - Credit scores,
  - Whether or not the financial exposure was subject to a forbearance program,
  - Alt-A/subprime exposures and then grouped by loan-to-collateral values, and/or
  - Hedged or unhedged exposures
- Exposures by asset class, grouped by:
  - Probability of default and loss given default,
  - On- or off-balance sheet status, and/or
  - Other risk factors
- Exposures split by hedged and unhedged exposure with:
  - Cumulative loss in value of hedged investments,
  - Cumulative gain on hedged investments, and
  - Net losses on hedged investments

[61] Not all sub-categories were included in a single presentation.

- Fair values of exposures by type of exposure and fair value measurement method (i.e., Level 1, Level 2, or Level 3 fair values)

4) Accounting classification and risk disclosures

Reconciliation

Accounting standards may require items on the balance sheet to be disclosed by accounting classification. However, because risk exposures can cut across accounting classifications it may be difficult for users to understand the relationship between accounting information and risk disclosures. User understanding of risk exposures could be enhanced if financial institutions were to provide information that would enable users to reconcile the two sets of information, such as risk exposure disclosures broken down by accounting classifications.

5) Risk characteristics

Choice of risk characteristics

Accounting and regulatory standards for credit risk disclosures focus on the creditworthiness, measured, for example, by external or internal credit ratings or past due status as well as the amount of collateral held against loans, and concentration of risk exposures by geographic region or industry. When risk disclosure principles are developed consideration could be given to providing guidance on disclosures about significant risk concentrations, the riskiness and valuation uncertainty/volatility of the portfolio, and relevant information on losses.

Examples of risk disclosures on structured credit exposures that might be insightful include:

- Differentiation between cash losses and unrealised mark-to-market losses;
- Description of illiquidity impacts on bonds (credit default swap pricing adjustments); and
- Expected losses on securitisation exposures.

6) Balance between quantitative and qualitative disclosures

This thematic review indicated that qualitative disclosures are very important; numbers alone often do not provide a full explanation of risk profiles and risk management practices. This would be a useful area to address in when developing the enhanced disclosure principles. Such principles could highlight where qualitative disclosures are particularly useful (for example, providing key strategic information so users can understand the unique risk profile of an institution). At the same time such principles could also discuss how to avoid burying important information in lengthy qualitative paragraphs or detailed quantitative information.