PUBLIC DISCLOSURE OF

THE TRADING AND DERIVATIVES ACTIVITIES

OF BANKS AND SECURITIES FIRMS

Joint report by the
Basle Committee on Banking Supervision
and the
Technical Committee of the International Organisation of Securities Commissions
("IOSCO")

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Contents

EXECUTIVE SUMMARY

This document surveys annual report disclosures about the trading (on-balance-sheet instruments and off-balance-sheet derivatives) and non-trading derivatives activities[1] of a sample of large, internationally active banks and securities firms in the G-10 countries, comparing their disclosures in 1994 with those of 1993. The institutions reviewed were primarily large dealers rather than end-users of derivatives. The survey is intended to provide internationally active banks and securities firms with a picture of the type of information currently disclosed by their peers at the international level. The report also contains recommendations for further improvements in banks' and securities firms' public disclosures about their trading and derivatives activities. These recommendations draw on the concepts developed in the *Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries* ("the Fisher report"), released by the Euro-currency Standing Committee of the G-10 central banks in September 1994 and on the *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* ("the Supervisory Information Framework"), released jointly by the Basle Committee on Banking Supervision[2] and the IOSCO Technical Committee[3] in May 1995. Since 1993, other bodies, including industry groups as well as national and international accounting authorities, have also launched important initiatives to improve public disclosures, notably with regard to derivatives activities.

While the emphasis of this report is on public disclosures by banks and securities firms, the two Committees hope that other financial institutions and non-financial companies with significant involvement in trading and derivatives activities will consider the concepts and recommendations presented in this report.

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1 From now on referred to as "trading and derivatives" activities. Annex 4 of the May 1995 paper of the Basle Committee and the IOSCO Technical Committee, *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms,* provides a more detailed definition of what is meant by trading and non-trading activities.

2 The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

3 The Technical Committee of IOSCO is a committee of the supervisory authorities for securities firms in major industrialised countries. It consists of senior representatives of the securities regulators from Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Mexico, Netherlands, Spain, Sweden, Switzerland, United Kingdom, and the United States.

The trading and derivatives activities of large banks and securities firms have grown rapidly and become more complex in recent years relative to more traditional on-balance-sheet activities and disclosure practices have tended to lag behind these developments. While the analysis of this document reveals that there have been improvements in 1994 disclosures of trading and derivatives activities, as compared to 1993, there remain significant differences across large, internationally active banks and securities firms with respect to the type and usefulness of information disclosed.

Against this background, the Basle Committee and the IOSCO Technical Committee strongly encourage banks and securities firms to continue their efforts to provide enhanced, meaningful[4] disclosures, both quantitative and qualitative, about how trading and derivatives activities contribute to the institution's overall risk profile and profitability, combined with information on risk management practices and the actual performance in managing the risks arising from these activities. While the focus of this report is on trading and derivatives activities, this should not detract from the importance of also enhancing the adequacy of disclosure practices for on-balance-sheet activities more generally. However, the two Committees chose to focus first on trading and derivatives activities because of their rapid growth and complexity, as well as the speed with which exposures in this area can be altered. The challenge for banks and securities firms is to develop disclosure practices that reflect these activities in a meaningful fashion.

The Committees' recommendations follow two main themes. First, as recommended in the Fisher report, enhanced disclosures should be based on information drawn from an institution's internal risk measurement and management systems and enable financial statement users to assess a firm's performance in managing material exposures to credit risk, market risk, liquidity risk, as well as the impact of trading and derivatives activities on earnings. Drawing on internal systems would help ensure that disclosure practices continue to improve with innovations in risk measurement and management techniques, particularly in rapidly evolving areas such as market risk and that the costs of generating disclosures are contained.

Second, institutions should provide financial statement users with a clear picture of their trading activities and overall involvement in the derivatives markets (both OTC and exchange-traded), as well as the impact of these activities on earnings. For guidance about fundamental disclosures about their derivatives activities (trading and non-trading, including related on-balance-sheet positions, where appropriate), institutions are encouraged to look to the common minimum framework presented in the Supervisory Information Framework paper. Although the common minimum framework was developed for the purpose of meeting

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4 The term "meaningful" is used in relation to "information" and "disclosure" as indicative of their usefulness and sufficiency for the users and readers of financial statements who might need to make decisions on the information.

certain information needs of supervisors of banking institutions and securities firms, it can also serve as a useful reference point for the public disclosure of meaningful information about the nature and scope of an institution's involvement in the OTC and exchange-traded derivatives markets, as well as the credit risk and to a certain extent, market liquidity risk[5], arising from these derivatives activities. Moreover, the minimum framework contains definitions of concepts that could improve the comparability of basic derivatives disclosures across internationally active institutions.

Improvements in disclosures about trading and derivatives activities can reinforce the efforts of supervisors to foster financial market stability in an environment of rapid innovation and growing complexity. If provided with meaningful information, investors, depositors, creditors and counterparties can impose strong market discipline on financial institutions to manage their trading and derivatives activities in a prudent fashion and in line with their stated business objectives. Improved disclosures should also benefit large, internationally active banks and securities firms themselves, enhancing their ability to evaluate and manage their exposures to other counterparties. This is particularly important since, in the area of trading and derivatives activities, a large proportion of business is conducted among large banks and securities firms.

The survey data and the recommendations contained in this document relate to banks' and securities firms' trading and derivatives activities mainly on a group-wide, consolidated basis. While disclosure on a consolidated basis is, in many cases, essential to gain an understanding of the overall trading and derivatives activities of a bank or securities firm, for the purposes of evaluating an institution's credit risk or other aspects of a counterparty's risk profile, it may also be necessary to consider the financial condition of individual subsidiaries and affiliates within the consolidated group.

The rest of this document is organised as follows: Section I discusses the benefits of enhanced public disclosure of trading and derivatives activities. Section II compares the 1994 and 1993 trading and derivatives disclosures of a sample of large, internationally active banks and securities firms in the G-10 countries. Section III provides recommendations for further improvements in disclosures about the trading and derivatives activities of internationally active banks and securities firms.

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5 Market liquidity risk is the risk that a position cannot be eliminated quickly by either liquidating the instrument or by establishing an offsetting position.

Public disclosure of the trading and derivatives activities of banks and securities firms

I. Benefits of enhanced trading and derivatives disclosures

For a number of years now, the trading and derivatives activities of large G-10 banks and securities firms have generally grown more rapidly than their traditional activities. For many of these institutions, notional amounts of off-balance-sheet derivatives transactions (indicative of overall activity in this area) now often exceed on-balance-sheet positions by a multiple. Even when measured in terms of credit-equivalent amounts, for many large institutions, derivatives activities are significant in relation to traditional on-balance-sheet positions. In addition, trading activities, involving both derivatives and on-balance-sheet instruments, have grown rapidly over recent years and, for many large dealer banks and securities firms, contribute significantly to total earnings.

While trading and derivatives activities generally involve types of risks that are similar to those associated with more traditional activities of banks and securities firms, the rapid growth and complexity of these activities pose new challenges for these institutions and their supervisors. Supervisors have increasingly endeavoured to develop supervisory tools that draw on the sophisticated systems that institutions have developed for internal risk measurement and management purposes. The responsibility for risk management and control continues to lie first with institutions themselves, with supervisors setting minimum standards combined with positive incentives to ensure the prudent measurement and management of risks by banking organisations and securities firms. For example, under the Basle Committee's market risk proposals released for industry comment in April 1995, banks would have the possibility to use their internal risk measurement models as a basis for determining their market risk capital requirements, subject to a series of minimum quantitative and qualitative standards.

The objectives of supervision can be reinforced through the public disclosure of information about how a bank or securities firm's trading and derivatives activities contribute to its overall risk profile and profitability and how well it manages the risks arising from these activities. Meaningful and accurate information reported in a timely manner provides an important foundation for the decisions of market participants. Well-informed investors, depositors, customers, creditors and counterparties can impose strong market discipline on an institution to manage its activities in a manner that is both prudent and consistent with its stated business objectives. Strong internal risk management and controls by banks and securities firms, reinforced through prudential supervision and enhanced public disclosure practices provide a sound framework for fostering market stability in an environment of rapid financial innovation and increasing complexity.

Banks, securities firms and other financial market participants should themselves be interested in enhanced and more meaningful disclosures of their trading and derivatives activities. Such disclosures can provide an institution with a clearer picture of the risk profile of its counterparties, thus enabling it to better manage its risks and to arrive at more informed business decisions. Moreover, an institution that provides little information about its risk profile may be susceptible to market rumours and misunderstandings by market participants in times of stress, which could possibly result in loss of business with counterparties, a higher cost of capital and funding difficulties.[6]

It is important that the disclosure practices of banks and securities firms reflect and keep pace with the growth and innovation of their trading and derivatives activities and the internal systems used to manage these activities. Ideally, public disclosures should be consistent with approaches that institutions use internally to measure and manage risk, thus capturing enhancements in risk management practices over time. Drawing on information already produced internally for risk management purposes should also reduce costs and the burden of enhanced public disclosures.

As a guiding principle, public disclosures should focus on key information about an institution's material trading and derivatives activities. The two Committees recognise that even among large, internationally active banks and securities firms, there are differences in the scope and nature of institutions' trading and derivatives activities. For example, some institutions are wholesale market makers in a range of cash and derivative instruments, while others primarily use derivatives for their own risk management purposes. The extent of information disclosed about trading and derivatives activities should stand in proportion to the importance of these activities to the institution's overall business, earnings and risk profile. Moreover, as a general principle, institutions should balance quantity, quality and usefulness of the information disclosed.

The Committees note that while the focus of this report is on trading and derivatives disclosures, this should not detract from the importance of continued assessments by banks and securities firms of the adequacy of their public disclosures in other important areas, such as investment, funding and, in the case of banks, lending activities and the impact of these activities on earnings. However, because of the rapid growth and complexity of institution's trading and derivatives activities and the speed with which exposures and earnings from such activities can change, the Committees chose to concentrate first on this area of disclosure.

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6 The Committees recognise that institutions' trading and derivatives positions may change significantly over time and that annual report disclosures can only provide a picture of a firm's past performance in managing its risk exposures. However, such disclosures provide an important context for evaluating how well a firm is able to manage its current trading and derivatives activities.

In this context, the remainder of this paper surveys large, internationally active banks' and securities firms' disclosures about their trading and derivatives activities in 1994 annual reports and the progress made since 1993 and it makes recommendations for further improvements in disclosure practices. These recommendations draw on the concepts developed in the *Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries* ("the Fisher report"), released by the Euro-currency Standing Committee of the G-10 central banks in September 1994 and on the *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* ("the Supervisory Information Framework"), released jointly by the Basle Committee on Banking Supervision and the IOSCO Technical Committee in May 1995. While the emphasis of this report is on large banks and securities firms, the concepts and recommendations also apply to other financial and non-financial institutions with significant trading or derivatives activities.

The Committees note that improvements in disclosure practices should not substitute for domestic and international efforts to develop sound accounting standards (including appropriate standards for measurement) for trading and derivatives activities. Like disclosure requirements, improved accounting standards are a necessary step to efficient market discipline and supervision. Accounting standards provide the foundation for credible and comparable financial statements and other financial reports. Fundamentally, such standards should define how the trading and derivatives instruments of banks and securities firms are valued and how they affect assets, liabilities and equity reported on the balance sheet and reported profits and losses. Thus, it is particularly important that accounting standard-setting organisations, industry groups and regulators continue to press for enhancements and, to the extent possible, future harmonisation of accounting standards for the trading and derivatives activities of internationally active banks and securities firms, as well as other financial and non-financial firms. However, the lack of harmony in accounting standards should not hinder meaningful disclosure of institutions' risk management activities, because such disclosure conveys information that current national accounting conventions may not necessarily provide.

As a cautionary note, the survey data and the recommendations contained in this document relate to banks' and securities firms' trading and derivatives activities mainly on a group-wide, consolidated basis. While disclosure on a consolidated basis is, in many cases, essential to gain an understanding of the overall trading and derivatives activities of a bank or securities firm, for the purposes of evaluating an institution's credit risk or other aspects of a counterparty's risk profile, it may also be necessary to consider the financial condition of individual subsidiaries and affiliates within the consolidated group.

II. Survey of disclosures about trading and derivatives activities of internationally active banks and securities firms in the G-10 countries

This survey of trading and derivatives disclosures focuses on the 1994 and 1993 annual reports of 67 banks and 12 securities firms, representing a sample of large, internationally active institutions in the G-10 countries (summarised in Tables 1-6). For the most part, these institutions represent the largest banks and securities firms involved in derivatives in their countries, as measured by the total notional amounts of derivative instruments.[7] The institutions reviewed are listed in Table 1, which presents the notional amount of the institutions' off-balance-sheet derivatives positions in the national currency and in U.S. dollars at the closing date of the financial statements.

The tabulation of disclosures is in part a subjective exercise and this review required criteria and judgements to determine whether or not an institution had made a particular disclosure. For example, one bank or securities firm might explicitly provide certain quantitative information, whereas in another bank's or securities firm's annual report, similar information might only be inferred from other complementary data. For purposes of this analysis, indirect communication of information was generally not included in the tables.

For a group of institutions as diverse as those reviewed in the survey, it is not unusual to observe large differences in the scope and nature of their trading and derivatives activities. In addition, it should be noted that the scope of an institution's disclosure is not necessarily indicative of the extent or quality of that institution's risk management and other functions. Moreover, the disclosure survey results summarised in Tables 2-6 (and subsequent recommendations) are not intended to prescribe specific kinds of information for disclosure purposes, but instead are intended to encourage voluntary efforts to improve disclosures by

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7 The internationally active banks and securities firms included for each country were those headquartered in the country and not subsidiaries of foreign banks or securities firms. Luxembourg banks were not included in this analysis, since the large dealers and end-users of derivatives located in Luxembourg are subsidiaries of banks centred in other G-10 countries. Large, internationally active banks for which Luxembourg authorities carry out consolidated supervision tend to be moderate end-users of derivatives instruments.

In a number of jurisdictions, the largest institutions involved in securities activities are either universal banks or majority-owned subsidiaries of internationally active banks. Thus, in order to avoid double counting, the securities firm portion of this analysis focuses on the stand-alone securities firms of the United States and Japan. Securities firms in France, Italy, the Netherlands, Spain, and one major United States broker-dealer, CS First Boston, Inc., were excluded. Firms in these countries and CS First Boston, Inc. are subsidiaries of bank holding companies and, accordingly, are included as applicable in the disclosure analysis for the large, internationally active banks, as are the securities activities of the major universal banks in the G-10 countries.

In the case of Japan - where the close of the annual reporting cycle is March 31, 1995 - the choice of institutions included in Table 1 also depended on the availability of financial statements at the time of the writing of this report. For Canadian banks, the close of the annual reporting cycle is October 31, 1994.

In some cases, there were differences in the scope of disclosure provided in domestic as compared to foreign language annual reports.

providing a picture of the types of disclosures provided last year by internationally active institutions. Thus, while the information on trading and derivatives disclosures included in Tables 2 through 6 is extensive, the tables are not intended to imply recommendations for "best practice" disclosures. Indeed, what is sought is not inordinate detail, but succinct, illuminating disclosures about the major risks managed by an institution and the potential earnings impact of these risk management activities.

Substantial enhancements were made in the 1994 annual reports of many of the 67 internationally active banks reviewed in this section, as compared to their 1993 reports. Trading and derivatives disclosures in 1994 annual reports of the major international securities firms improved as well compared to their 1993 reports. In particular, for the first time a number of leading global financial intermediaries provided quantitative information on market risk exposures drawn from their internal risk management systems. More information was also provided on credit risk exposures and management discussions of trading and derivatives activities were expanded in comparison to 1993. It appears that the initiatives undertaken since 1993 by national and international financial accounting standard setters, industry groups, central banks and national supervisors have made important contributions that helped to enhance the overall quality of trading and derivatives disclosures.

Despite these encouraging improvements, there remain significant disparities across large, internationally active banks and securities firms with respect to the type and usefulness of information disclosed about their trading and derivatives activities. Indeed, some institutions continued to disclose very little about these activities. Differences in the detail and information content of public disclosures can be attributed to a number of factors, including statutory provisions and other national standards and requirements for accounting and disclosure; the information needs communicated by investors, creditors and other financial statement users; and differences in tradition concerning, for example, the mix between public disclosure and reporting to supervisors. In addition, as one might expect, in many cases the extent of a bank's or securities firm's trading and derivatives disclosures depends on the importance of these activities in the institution's overall business activity.

However, the types of institutions covered in this analysis have in common that they generally employ risk measurement and management systems that generate periodic information for internal use by management, as well as for the use of boards of directors. In addition, these banks and securities firms provide supervisors with extensive information, often on a confidential basis, about their trading and derivatives activities through channels such as periodic reports, on-site examinations or external audits and discussions with senior management. For example, as part of the Derivatives Policy Group's "Framework for Voluntary Oversight," the major United States securities firms that are derivatives dealers are providing to U.S. supervisors detailed credit risk and market risk information on the over-the-counter derivatives activities conducted in their unregulated entities. As argued in the Fisher Report, the challenge for banks and securities firms is to draw on information already

produced for internal risk management purposes and to communicate it in summary form to the public in a manner that provides a clear and meaningful picture of how trading and derivatives activities contribute to the overall risk profile and profitability of the institution and how well the institution manages this risk.

For the vast majority of the institutions reviewed, disclosure about trading and derivatives activities is provided on a consolidated basis and appears in two main places in the annual report:

- **Management's discussion and analysis.** This is an analysis of the firm's financial condition and performance (including financial data) that typically includes a narrative of the firm's risk exposures and techniques for managing risk. This part of the annual report is not typically audited by independent accountants. In some countries, this portion of the annual report may be referred to as the financial review or management report.

- **Annual financial statements.** These financial statements generally include the statements of financial position (balance sheet), income, changes in stockholders' equity and changes in financial position or cash flow. Footnotes, which present information on financial statement line items in narrative and tabular form, are also considered to be a part of the financial statements. The annual financial statements and their footnotes are audited by independent accountants.

This survey considers disclosures in both of these areas of the annual report.

The remainder of this section presents in greater detail developments in qualitative and quantitative disclosures of trading and derivative activities since 1993. In reviewing quantitative trading and derivatives disclosures, the report addresses information about gross position indicators, credit risk, market risk and earnings. Market risk and earnings information is broken down by trading and non-trading (e.g. end-user) activities.[8] The qualitative and quantitative information is summarised in Tables 2-6 at the end of this section.

(A) Comparison of 1993 and 1994 annual reports

(1) Qualitative information

As indicated in Table 2, with respect to qualitative disclosures, the majority of the banks and securities firms covered in the survey discussed in some form the various risks associated with their trading and derivatives operations and their processes for controlling

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8 In some countries, it is customary to distinguish derivatives as being held for either trading or end-user purposes. Other countries identified derivatives as being held for dealing purposes or hedging purposes, or used other designations.

their exposures. By comparison, in 1993, significantly fewer institutions provided such qualitative information.

A majority of institutions provided a general discussion of the objectives and strategies of their trading (cash and derivatives) and non-trading derivatives activities. Moreover, a number of the larger organisations included in this review discussed their risk control processes by identifying the management groups responsible for setting trading policies and describing the managerial functions that are responsible for ensuring compliance with these policies.

Forty-eight banks and 10 securities firms included bonds and other cash market financial instruments within the scope of their narrative of risk management, an approach that provides a more balanced, broad-based discussion of managing risk exposures than would a strict focus on derivatives. Over forty of the 67 banks and 12 securities firms discussed measurement and control of credit and market risks. Many of these institutions did so with reference to quantitative information on the development of market and credit risk exposures over the reporting period and this provided greater focus to the discussion. Thirty-one banks and seven securities firms described how they manage the liquidity demands of their operations. Fourteen banks and seven securities firms summarised in their management discussion and analysis how they control operating and legal risks; by comparison five banks and three securities firms provided such information in 1993. In addition, five organisations indicated in their 1994 reports whether or not they used complex instruments such as leveraged derivatives (contracts using multipliers or other means to scale up cash flows relative to the reported notional amount) in their business.

Most countries have requirements (or disclosure practices) that call for banks and securities firms to disclose in annual reports their accounting policies and methods, including those applicable to trading and derivatives activities. Under these standards, banks, securities firms and other companies are expected to discuss accounting policies and to describe how traded instruments and derivatives are valued and how income and expense on these instruments are recognised in the financial statements.

While companies have long been expected to describe their accounting policies in their annual reports, generally, there was much greater specificity of these disclosures in 1994 reports. Almost all of the sample banks and 10 of the 12 securities firms provided disclosures about their accounting policies for derivatives. More recently, banks and securities firms in some countries have started disclosing the fair value of financial instruments together with summary information on how they determine fair value. Thirty-three of the banks (an increase from 14 in 1993) and 12 securities firms (the same as in 1993) provided a general discussion of the methods and assumptions used in valuing financial instruments, including those that do not have observable market prices. While the majority of institutions reviewed provided a discussion of their accounting policies and valuation techniques, there remain significant differences across institutions regarding the level of detail provided for such disclosures.

(2) Quantitative information

Table 3 presents an overview of disclosures made about notional amounts and market values of instruments held for trading purposes (on- and off-balance-sheet) and derivatives held for non-trading purposes. These measures are indicative of the extent of an institution's involvement in derivatives instruments.

The 67 banking institutions and 12 securities firms continued to expand disclosures of the general contractual terms of their derivative contracts. In 1994, all of the 67 banking institutions and 12 securities firms provided information on the notional amounts of their derivatives holdings, compared to 57 and 10, respectively, in 1993. Also, these institutions generally provided further instrument detail on their derivatives positions. Moreover, in 1994, almost half of the banking institutions and all of the securities firms identified their trading derivatives positions. Twenty-five banks chose to distinguish exchange-traded contracts from over-the-counter instruments, generally through disclosure of the notional amounts related to futures contracts and exchange-traded purchased options versus over-the-counter contracts. This type of information was provided by 13 banks in 1993. The securities firms generally identified and qualitatively described the trading characteristics (e.g., listed vs. over-the-counter) of derivative instruments and products within the context of an overall discussion of a firm's business products and services.

Thirty-one banks provided a combined maturity schedule (trading and non-trading positions) for the notional amounts of their derivatives holdings, whereas 15 banks provided such a schedule last year. Seven securities firms provided a maturity schedule for trading positions and three firms provided such information on non-trading positions in 1994. Thirty banks this year reported gross positive market values and 13 the gross negative market values of their derivative positions as of the report date, a significant increase from the number of institutions providing this information in 1993. All 12 securities firms disclosed both gross positive and gross negative market values in 1994 annual reports, representing an increase from seven firms in 1993 annual reports.

With regard to instruments held for trading purposes, 27 banks and 12 securities firms distinguished trading account assets from trading account liabilities and 41 banks and 11 securities firms provided details about their traded cash instruments as of year end. In 1994 there was a significant increase in the number of institutions supplementing these cash position disclosures with information on derivatives held for trading purposes at year end. Thirty-three banks and 11 securities firms provided such information in 1994 as compared to 15 and 6, respectively, in 1993. For the first time in 1994, seven banks presented reporting period averages for the market values of their cash instruments held in the trading account and eight also provided this information for trading account derivatives. Eight securities firms presented such information for derivatives instruments in 1994 versus three in 1993.

Institutions also provided more information about their non-trading derivatives activities. In 1994, 19 banks and 2 securities firms disclosed the overall market value of their non-trading derivatives portfolio, compared to 16 and zero, respectively in 1993.

Credit risk

As indicated in Table 4, a significant number of the banks reviewed provided more information on credit risk in their 1994 annual reports. With respect to the securities firms, the most significant increase in credit risk disclosures was in the area of counterparty credit quality. The most common type of banking institution disclosure involved the risk-based capital credit-equivalent amounts of derivatives (current credit exposure and potential credit exposure combined); 45 banks disclosed this information in 1994, up from 34 banks in 1993. The next most prevalent type of disclosure was information on gross positive market values (also sometimes referred to as the gross replacement cost), which does not include the risk-reducing benefits of legally enforceable netting arrangements or collateral. Thirty of the 67 banks provided information on gross positive market values in 1994, compared to 19 in 1993. While 15 banks reported their current credit exposure in 1993 (positive replacement value taking account of bilateral netting agreements), 29 disclosed this information in 1994. For securities firms, two more firms provided current credit exposure information in 1994 annual reports than in 1993.

In 1994, twenty-one banks and six securities firms provided information on the credit quality of their derivatives portfolio, compared to five and one, respectively, in 1993. These institutions generally provided a breakdown of their derivatives credit exposure either by rating agency gradations, by internal ratings, or by categories similar to those of the Basle Capital Accord (for banks). Moreover, in 1994, twenty-five banks and six securities firms published information about credit exposure concentrations for their derivatives portfolios, compared to six and five, respectively, in 1993. Twenty-four banks and six securities firms provided credit concentration information according to industry category and 16 banks and 4 securities firms disclosed such information by geographical concentration.

With regard to other measures of credit risk, nine banks separately identified their potential credit exposure. One of the 67 banks provided a measure of the volatility of credit exposure arising from derivatives. Two institutions reported the value of collateral and other credit enhancements connected with their trading and derivatives portfolios. In 1993, four banks quantified their actual derivatives credit losses and one disclosed its non-performing derivatives contracts. In 1994, nine banks provided information about derivatives credit losses and eight about non-performing contracts (or they stated that such credit losses and non-performing contracts were immaterial).

Market risk

Trading activities

One of the most notable changes in disclosures in 1994 was the provision by many leading global intermediaries of quantitative information drawn from their risk management systems on their exposures to market risk (Table 5). In 1994, 18 banks provided quantitative market risk information, compared to four firms in 1993. Most institutions disclosing market risk exposures used a value-at-risk approach, comprising cash and derivative instruments. A number of institutions provided a histogram of daily value-at-risk estimates over the reporting period. Seven disclosed high/low values and ten of the 18 institutions provided an average value-at-risk estimate for the 1994 reporting period. A number of firms split their market risk disclosures by proprietary and client-related trading activities and other firms provided value-at-risk information by broad underlying risk factors. Banks also provided information about the statistical assumptions and aggregation criteria underlying their value-at-risk estimates.

As recommended in the Fisher report, a number of banks also provided for the first time in 1994 information on the actual changes in the value of the portfolios to which the value-at-risk estimates applied, enabling annual report users to assess the firms' performance in managing market risk exposures. A number of firms contrasted daily value-at-risk estimates with actual outcomes directly, thus revealing the frequency with which changes in portfolio value exceeded value-at-risk estimates. Other indicators of trading outcomes included histograms or scatter plots of daily changes in portfolio value and annual high/low and average changes in portfolio value. A few securities firms provided histograms of weekly trading results, both at the aggregate portfolio level as well as for sub-portfolios.

Historically, the major securities firms have not provided quantitative market risk disclosures of their trading and derivatives activities in their annual reports. As part of the Derivatives Policy Group's "Framework for Voluntary Oversight" on over-the-counter derivatives, the major U.S. derivatives dealers are providing to United States supervisors on a quarterly basis measures of "capital-at-risk", defined as the maximum loss expected to be exceeded with a probability of one percent over a two-week period. In addition, these dealers provide supervisors with the results of a series of core risk factor stress tests of their over-the-counter derivatives portfolios.

Non-trading derivatives activities

The most common form of disclosure by the surveyed banking institutions that used derivatives for non-trading purposes involved schedules of notional amounts, maturities and (for swaps) contractual rates paid and received. For both 1994 and 1993, the most prevalent means of conveying how derivatives are used to manage a bank's interest rate risk

was a gap position schedule (used by 25 banks, compared to 23 in 1993).[9] Many banks publishing a gap schedule for interest rate risk cautioned that it represented only a point-in-time picture of risk and did not capture options risk and other dynamic characteristics of the balance sheet. Four banks furnished quantitative information on their value-at-risk measures related to non-trading derivatives. Fourteen banks provided a discussion of the effect on capital or earnings of a specified rate shock. Two banks disclosed the duration of derivatives held for risk management purposes. A few of the banks providing information on their non-trading derivatives holdings described in varying detail whether the derivatives were linked to specific components of the balance sheet or were used to manage overall risk exposures.

Earnings

Trading activities

As indicated in Table 6, 51 banks and eight securities firms provided information on the impact of their trading activities on earnings (whether cash, derivatives, or both), compared with 45 banks and three securities firms, respectively, in 1993. Of these institutions, ten banks and eight securities firms reported their trading income by risk category or by line of business, cash-market and derivative instruments combined. Eleven banks and two securities firms reported trading results according to the type of instrument that earned the income. Twenty-one banks and two securities firms provided a distinction between earnings from cash instruments and earnings from derivatives positions. Thirty-five banks also disclosed net interest revenue from traded cash positions.

Non-trading derivatives activities

With regard to derivatives instruments held for non-trading purposes, details of how these instruments affect "accrual-based accounting" income and expense (that is, where instruments are not marked to market with gains or losses recognised in income, but are instead accounted for on a historical cost basis) were more widely reported in 1994 than in 1993. Eleven banks reported the effect that derivatives accounted for on an accrual basis had on revenue, compared with five last year. Twelve banks and six securities firms reported the overall effect on net interest margins of their non-trading derivatives activities. Eight banks disclosed deferred gains or losses on non-trading derivatives and six banks provided information on when the deferrals would be reflected in future earnings. Eighteen banks and three securities firms disclosed the unrealised gains and losses associated with non-trading derivatives positions, an increase from ten and two, respectively, in 1993.

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9 Gap schedules disclosed by banks organise financial assets and liabilities according to maturity in a number of time bands. The difference between assets and liabilities in each time interval ("gap" or net exposure) forms the basis for assessing interest rate risk. Derivatives of various maturities can be used to adjust the net exposure of each time interval to alter the overall interest rate risk of the institution. Historically, securities firms have not presented gap table disclosures in their annual reports.

Table 1
Banks and securities firms included in survey
31 December 1994 (except as noted)
In alphabetical order, by country

Country	Institution	Notional Amounts (Billions) [1] National Currency	U.S. Dollars
Belgium	Bank Brussel Lambert	5,680	178
	Generale Bank	4,235	133
	Kredietbank	6,286	197
Canada [2]	Bank of Montreal	544	403
	Bank of Nova Scotia	502	372
	Canadian Imperial Bank of Commerce	805	596
	National Bank	81	60
	Royal Bank of Canada	949	703
	Toronto Dominion Bank	476	353
France	Banque Nationale de Paris	10,249	1,919
	Credit Agricole	3,758	704
	Credit Commerciale de France	3,225	604
	Credit Lyonnais	9,758	1,827
	Indosuez	4,991	935
	Paribas	11,436	2,142
	Societe Generale	17,479	3,274
	Union Europeene de CIC	1,551	290
Germany	Bank Gesellschaft Berlin	147	95
	Bayerische Hypotheken u. Wechselbank	176	114
	Bayerische Vereinsbank AG	447	288
	Commerzbank	608	392
	Deutsche Bank	2,186	1,410
	Dresdner Bank	733	473
	Westdeutsche Landesbank	534	345

[1] Notional amounts of off-balance-sheet derivative instruments

[2] Fiscal year-end (FYE) of 31 October 1994

Table 1(con't)
Banks and securities firms included in survey
31 December 1994 (except as noted)
In alphabetical order, by country

Country	Institution	Notional Amounts (Billions) National Currency	Notional Amounts (Billions) U.S. Dollars
United Kingdom	Barclays	954	1,490
	Hambros [4]	307	480
	HSBC	1,048	1,638
	Lloyds	739	1,154
	National Westminster	892	1,394
	Royal Bank of Scotland [5]	125	196
	Schroders	52	82
	Standard Chartered	142	221
United States			
Banks: [10]	Bank of New York Co.	80	80
	BankAmerica Corp.	1,376	1,376
	Bankers Trust N.Y. Corp.	1,982	1,982
	Chase Manhattan Corp.	1,367	1,367
	Chemical Banking Corp.	3,182	3,182
	Citicorp	2,665	2,665
	First Chicago Corp.	622	622
	J.P. Morgan & Co.	2,471	2,471
	NationsBank Corp.	511	511
	Republic New York Corp.	239	239
Securities firms:	The Bear Stearns Companies, Inc. [6]	89	89
	Donaldson, Lufkin & Jerrette, Inc.	27	27
	The Goldman Sachs Group, L.P. [7]	995	995
	Lehman Brothers Holdings, Inc. [7]	1,086	1,086
	Merrill Lynch & Co., Inc. [8]	1,169	1,169
	Morgan Stanley Group, Inc. [9]	835	835
	Paine Webber Group, Inc.	38	38
	Prudential Securities, Inc.	46	46
	Salomon, Inc.	1,470	1,470
	Smith Barney Holdings, Inc.	51	51

[4] FYE 31 March 1995
[5] FYE 30 September 1994
[6] FYE 30 June 1994
[7] FYE 25 November 1994
[8] FYE 30 December 1994
[9] FYE 31 January 1995
[10] Source: Publicly available regulatory financial statements filed with the Federal Reserve

Table 1(con't)
Banks and securities firms included in survey
31 December 1994 (except as noted)
In alphabetical order, by country

Country	Institution	Notional Amounts (Billions) National Currency	Notional Amounts (Billions) U.S. Dollars
Italy	Banca Commerciale Italiana	76,564	47
	Banca CRT	41,473	26
	Banca di Roma	45,817	28
	Banca Nazionale del Lavoro	54,341	34
	Banco Napoli	55,796	34
	Credito Italiano	70,354	43
	Istituto Mobiliare Italiano	69,328	43
	San Paolo di Torino	287,337	177
Japan [3]			
Banks:	Bank of Tokyo	103,965	1,197
	Fuji Bank	171,194	1,971
	Industrial Bank of Japan	163,320	1,880
	Long-Term Credit Bank of Japan	74,915	863
	Mitsubishi Bank	144,738	1,667
	Sanwa Bank	108,406	1,248
	Tokai Bank	74,206	854
Securities firms:	The Nikko Secutities Co., Ltd.	4,643	53
	The Nomura Securities Co., Ltd.	11,662	134
Netherlands	ABN-AMRO Bank	1,229	706
	ING Bank	373	214
	Rabobank	575	330
Sweden	Nordbanken	1,276	172
	Skandinaviska Enskilda Banken	3,090	416
	Sparbanken Sverige (Swedbank)	984	132
	Svenska Handelsbanken	2,271	306
Switzerland	Credit Suisse	2,096	1,600
	Swiss Bank Corp.	2,632	2,009
	Union Bank of Switzerland	2,250	1,718

[3] FYE 31 March 1995

TABLE 2

QUALITATIVE INFORMATION

	1993	1994	1994												
	No.	No.	**Belgium**	**Canada**	**France**	**Germany**	**Italy**	**Japan**		**Netherlands**	**Sweden**	**Switzerland**	**UK**	**US**	
								Banks	SF*					Banks	SF*
	n°	79	3	6	8	7	8	7	2	3	4	3	8	10	10
Discussion of Ojectives:															
Objectives & strategies for trading	38	58	2	6	8	6	0	7	2	0	4	0	5	9	9
Objectives & strategies for non-trading activities	37	57	2	6	8	6	0	7	0	1	4	0	6	10	7
Discussion of Risks :															
Placed in context with balance sheet risks	37	58	1	6	5	7	0	7	0	2	4	2	4	10	10
Discussion of specific risks:															
Credit risk - described how risk arises	34	55	1	5	5	6	0	7	2	1	2	3	4	9	10
* Risk management method described	30	56	1	6	5	6	0	7	2	1	1	2	6	9	10
Market risk - described how risk arises	35	56	0	6	5	7	0	7	2	0	2	3	5	9	10
* Risk management method described	29	58	1	6	5	7	0	7	2	1	1	3	6	9	10
Liquidity risk - described how risk arises	19	37	0	5	3	7	0	3	0	0	2	1	2	6	8
* Risk management method described	15	38	0	5	3	7	0	1	0	1	1	1	6	6	7
Operating & Legal Risks - described risks	10	26	0	4	0	1	0	6 [1]	0	0	2	1	1	3	8
* Risk management method described	8	21	0	4	0	1	0	4 [1]	0	0	1	1	1	2	7
Discussion of leveraged instruments	0	5	0	0	0	0	0	0	0	0	0	0	0	5	0
Discussion of How Market Values Estimated	26	45	0	3	8	7	0	1	2	0	0	3	1	10	10
Discussed - Accounting Policies for Derivatives	63	71	3	6	8	7	8	1	0	3	4	3	8	10	10

[1] Operational risk only

* Securities Firms

TABLE 3

GROSS POSITION INDICATORS

	1993	1994	1994												
	No.	No.	Belgium	Canada	France	Germany	Italy	Japan		Netherlands	Sweden	Switzerland	UK	US	
								Banks	SF*					Banks	SF*
Notional Amount Information:	n°	79	3	6	8	7	8	7	2	3	4	3	8	10	10
Total Notional Amounts	67	79	3	6	8	7	8	7	2	3	4	3	8	10	10
Trading positions	32	43	3 [1]	1	6	0	8	1	2	0	0	0	3	9	10
Non-trading positions	30	36	3	1	6	0	8	1	0	0	0	0	3	10	4
Distinguished OTC vs. Exchange Traded	13	25	1	0	8	7	0	0	0	0	1	3	2	3	0
Maturity Schedule															
Trading positions	6	16	0	0	1	0	0	0	0	0	0	0	2	6	7
Non-trading positions	9	16	0	0	1	0	0	0	0	0	0	0	2	10	3
Combined	15	31	1	5	1	7	8	1 [4]	-	0	4	2	1	1	-
Contract Rates:															
Summary information on receive/pay rate levels	4	16	0	1	0	0	0	0	0	0	0	0	2	10	3
Receive/pay notionals	18	30	0	1	8	0	8	0	0	0	0	0	2	10	1
Market Value Data															
Gross positive market value	26	42	0	6	3	5	0	0	2	0	0	3	6	7	10
Gross negative market value	13	25	0	1	0	0	0	0	2	0	0	0	6	6	10
Trading Account:															
Separate trading assets from trdg. liabilities	27	39	0	0	8	0	0	1	2	0	0	0	8	10	10
Cash instrument detail: end-of-period	42	52	0	6	8	0	0	7	2	0	4	0	8	8	9
average for period	0	7	0	0	0	0	0	1	0	0	0	0	0	6	0
Derivative instrument detail: end-of-period	21	44	3 [1]	1	0	7 [2]	0	7 [5]	2	0	3	0	3	9	9
average for period	3	16	0	0	0	0	0	0	0	0	0	0	1	7	8
No detail of trading account - just totals	18	9	0	0	0	0	8	0	-	0	0	0	0	1	-
Non-trading Derivatives Positions:															
Overall market value	16	21	0	1	0	0	0	7 [5]	0	0	0	0	2	9	2
By related asses/liability being hedged	6	13	0	0	0	0	0	1	0	0	0	0	1	9	2
By type of derivative	5	20	3	1	0	7 [3]	0	0	0	0	0	0	2	6	1

[1] Transactions not considered hedging, which are marked to market
[2] Combined with end-user positions
[3] Combinded with trading positions
[4] Swaps only
[5] Only exchange traded
* Securities Firms

TABLE 4

CREDIT RISK

	1993	1994	1994												
	No.	No.	**Belgium**	**Canada**	**France**	**Germany**	**Italy**	**Japan**		**Netherlands**	**Sweden**	**Switzerland**	**UK**	**US**	
								Banks	SF*					Banks	SF*
	n°	79	3	6	8	7	8	7	2	3	4	3	8	10	10
Current credit exposure (i.e., with netting)	22	38	1	1	4	7	0	0	2	0	0	2	4	10	7
Volatility of credit exposure	0	1	0	0	1	0	0	0	0	0	0	0	0	0	0
Gross positive market value	26	42	0	6	3	5	0	0	2	0	0	3	6	7	10
Potential credit exposure	1	9	0	5	0	0	0	0	0	0	0	1	1	2	0
Counterparty credit quality	6	27	1	3	3	7	0	0	0	0	0	2	0	5	6
Information on Concentrations	11	31	1	3	4	7	0	0	0	0	0	0	4	6	6
Exposure by geographic area	8	20	1	1	3	7	0	0	0	0	0	0	0	4	4
Exposure by industry groups	11	30	1	3	3	7	0	0	0	0	0	0	4	6	6
Other (e.g., exposures > x% of capital)	0	7	0	0	1	0	0	0	0	0	0	0	0	6	0
Collateral & other credit enhancements	0	2	0	0	0	0	0	0	0	0	0	0	0	2	0
Actual credit losses	4	9	0	2	0	0	0	1	0	0	0	0	0	6	0
Nonperforming contracts	1	8	0	1	0	0	0	1	0	0	0	0	0	6	0
For banks, RBC credit equivalent - derivatives	34	45	0	6	3	7	0	7	-	3	4	0	8	7	-

* Securities Firms

TABLE 5

MARKET RISK INFORMATION

	1993	1994	1994												
	No.	No.	Belgium	Canada	France	Germany	Italy	Japan		Netherlands	Sweden	Switzerland	UK	US	
								Banks	SF*					Banks	SF*
	n°	79	3	6	8	7	8	7	2	3	4	3	8	10	10
Trading Activities:															
Daily VAR	4	18	0	0	5	1	0	3	0	0	0	1	0	8	0
High/Low VAR	0	7	0	0	1	0	0	1	0	0	0	0	0	5	0
Average VAR	0	10	0	0	2	0	0	1	0	0	0	0	0	7	0
Confidence band determined by daily VAR	2	11	0	0	3	0	0	1	0	0	0	1	0	6	0
Daily change in value of portfolio [1]	0	5	0	0	1	0	0	0	0	0	0	0	0	4	0
Average daily change in value of portfolio	0	4	0	0	0	0	0	0	0	0	0	1	0	3	0
Change in portfolio value exceeded VAR	0	6	0	0	0	1	0	1	0	0	0	0	0	4	0
Non-trading Activities															
Effect of derivatives on duration	1	2	0	0	0	0	0	0	0	0	0	0	0	2	0
Effect of derivatives on gap position	23	25	0	5	0	0	8	2	0	0	0	0	2	8	0
Impact of specified rate shock	5	14	1	4	4	0	0	0	0	0	0	0	0	5	0
VAR for non-trading portfolios	0	4	0	0	0	1	0	0	0	0	0	0	0	3	0

* Securities Firms

[1] Some Securities firms provided information on weekly changes in portfolio value

TABLE 6

EARNINGS INFORMATION

	1993 No.	1994 No.	1994												
			Belgium	**Canada**	**France**	**Germany**	**Italy**	**Japan**		**Netherland**	**Sweden**	**Switzerlan**	**UK**	**US**	
								Banks	SF*					Banks	SF*
	n°	79	3	6	8	7	8	7	2	3	4	3	8	10	10
Trading Activities:															
Information on trading income	48	59	3	2	7	7	8	1	0	3	0	3	8	9	8
By risk exposure/line of business	8	18	0	0	0	0	0	1	0	0	0	3	1	5	8
By instrument type	12	13	0	1	3	0	0	0	0	0	0	0	0	7	2
By cash positions vs. derivative instruments	22	23	0	0	7	0	8	0	0	0	0	0	0	6	2
Other	29	29	3	1	0	7	8	0	0	3	0	0	7	0	0
Net interest revenue from cash positions	29	35	0	0	8	7	8	1	0	0	0	3	3	5	0
Non-trading Derivatives Revenue impact (amount or %)															
Of derivatives alone	5	11	0	1	0	0	0	1	0	0	0	0	1	8	0
Overall sensitivity of net interest margins	15	18	0	0	0	0	8	0	0	0	0	0	0	4	6
Amount of deferred gains/losses	7	8	0	1	0	0	1	0	0	0	0	0	1	5	0
Amortization period - deferred gains/losses	2	6	0	0	0	0	0	0	0	0	0	0	1	5	0
Unrealised gain or loss on derivatives	12	21	3	0	0	0	2	1	0	0	0	0	2	10	3

* Securities Firms

III. Recommendations

The previous section highlighted advances in key areas of annual report disclosures about trading and derivatives activities for a sample of internationally active banks and securities firms over the period from 1993 to 1994. This section focuses on recommendations for further improvements in disclosure practices of large banks and securities firms with significant involvement in trading and derivatives activities. The recommendations may also be useful for other financial and non-financial companies with significant trading and derivatives activities.

The Basle Committee and the IOSCO Technical Committee encourage banks and securities firms to continue their efforts to improve disclosure practices by providing meaningful summary information, both qualitative and quantitative, about their trading and derivatives activities. Disclosures should provide a picture of the scope and nature of an institution's trading and derivatives activities, as well as information on the major risks associated with these activities, including credit risk, market risk and liquidity risk. Institutions should also disclose information on the actual performance in managing these risks, particularly with regard to exposure to market risk.[10] In addition, disclosures should provide meaningful, summary information on how trading and derivatives activities contribute to an institution's earnings profile.

As discussed in the Fisher report, institutions are encouraged to disclose quantitative information on their risk exposures and on their performance in managing these exposures in a manner that is consistent with the methodologies employed in their internal risk measurement and performance assessment systems. This should help ensure that disclosure practices keep pace with innovations in risk management practices over time, particularly in areas undergoing rapid evolution such as market risk, where an increasing number of institutions are introducing or developing further their value-at-risk methodologies. Disclosures should focus on material risk exposures and the amount of information should stand in relation to the importance of the activity in the institution's overall business, risk profile and earnings.

For fundamental disclosures of an institution's derivatives activities (trading and non-trading, including related on-balance-sheet positions), institutions are also encouraged to look to the common minimum framework that is presented in the Supervisory Information Framework paper. The common minimum framework calls for information on an institution's overall derivatives market activity and exposure to credit and, to a certain extent, market

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10 To date, statistical approaches for measuring performance in managing credit risk have not been developed as extensively in banks and securities firms as have market risk performance measures. Therefore, measuring an institution's performance in managing credit risk is generally more difficult than for market risk at this time. As these statistical techniques are developed further and become established, institutions should disclose summary information consistent with these performance measurement techniques.

liquidity risks. The minimum framework can serve as a reference point for institutions that currently provide little or no quantitative information on their derivatives activities. Furthermore, disclosure of information that is consistent with the common minimum framework could improve the consistency and comparability of basic annual report disclosures.

The remainder of this section discusses these various points in greater detail, focusing first on qualitative disclosures and then discussing quantitative disclosures.

(A) Qualitative disclosures

Qualitative disclosures should provide an overview of an institution's overall business objectives, its risk-taking philosophy, how trading and derivatives activities fit into these overall objectives, as well as the principal internal control procedures that are in place for managing these activities. In addition, qualitative disclosures provide management with the opportunity to elaborate on and provide depth to the quantitative disclosures provided in the annual report.

More specifically, banks and securities firms are encouraged to consider the following types of summary qualitative information about their trading and derivatives activities:

Risks and management controls

- An overview of key aspects of the organisational structure central to the institution's risk management and control process for its trading and derivatives activities.
- A description of each of the major risks arising from an institution's trading and derivatives activities (including credit risk, market risk, liquidity risk, operational and legal risk) and the methods used to measure and manage these risks (for example limit policies for exposures to market risk and credit risk and how value-at-risk measures are used to manage market risks). In addition, a discussion of how the institution assesses its performance in managing these various risks.
- Information about the overall objectives and strategies of trading activities (involving all on- and off-balance-sheet components) and whether the institution is a wholesale market maker, engages in proprietary trading, or takes positions as an accommodation to customers.
- In the case of non-trading derivatives activities, a description of the general objectives for these activities. For example, in the case of banks, such disclosures could clarify how these instruments are being used to hedge risks inherent in banking activities such as foreign exchange or interest rate risk, or, where relevant, if they are being used for other risk management activities.

- A summary of activity in and the risks associated with high risk instruments or complex instruments such as leveraged derivatives.

Accounting and valuation methods

- A discussion of the accounting policies and methods of income recognition that apply to trading activities (involving both cash instruments and derivatives) and to non-trading derivatives activities. Disclosures about accounting polices should be sufficient to enable the user of financial statements to understand important distinctions that may exist in the accounting treatments of various types or uses of derivatives instruments. In the absence of clear accounting standards for many types of derivatives activities, it is particularly important that an institution discuss the accounting treatments applied to its various derivatives holdings. For example, it would be useful to summarise the methods used to account for derivatives, the types of derivatives accounted for under each method and the criteria to be met for each accounting method to be used (e.g. criteria for recognising hedges). Furthermore, institutions are encouraged to specify the accounting treatment applied if the criteria for a given method are not met. Other important types of information include the accounting treatments for terminations of derivatives contracts, derivatives that are hedges of anticipated transactions, balance sheet netting of assets and liabilities arising from derivatives and credit losses on derivatives instruments.
- A general discussion of the valuation methodologies used as well as information on whether adjustments are made after positions have been market to market. In the case of instrument categories for which there are no quoted market prices, a general discussion of the market value estimation techniques used and a summary of the procedures for checking the accuracy of these estimates.

For background on the types of qualitative information about derivatives and related activities that may be appropriate for disclosure purposes, banks are encouraged to consider the report, *Risk Management Guidelines for Derivatives* and securities firms the report, *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms.* These reports were issued, respectively, by the Basle Committee and the IOSCO Technical Committee with a joint cover note in July 1994 and they highlight key attributes of the risk management systems of banks and securities firms.

(B) Quantitative disclosures

(1) Market activity, credit risk and market liquidity

Large, internationally active banks and securities firms should provide summary information about the composition of their trading portfolios. This information could include the end-of-period and average market values of major categories of on- and off-balance-sheet instruments held for trading purposes. Moreover, this disclosure could distinguish between trading assets and trading liabilities.

With regard to derivatives activities (trading and non-trading), institutions should provide financial statement users with a clear picture of their involvement in the derivatives markets, both OTC and exchange-traded. Institutions could draw from the common minimum framework of the Supervisory Information Framework paper for guidance about basic disclosures of their derivatives activities and how these activities affect the overall risk profile of the institution. Where appropriate, institutions are encouraged to place information on derivatives in the context of related on-balance-sheet positions.

The common minimum framework is presented in detail in Section III. and Annex 3 of the Supervisory Information Framework paper. It focuses primarily on meaningful summary information relating to overall market activity, credit risk and, to a certain extent, market liquidity. Information on market activity is provided by broad risk category (interest rate, exchange rate, precious metals, other commodities and equities), by broad instrument category (futures, forwards, swaps and options) and by maturity band (one year or less, over one year to five years, greater than five years). The minimum framework provides insight into whether derivatives are used primarily for trading or non-trading purposes (e.g. hedging) and whether an institution is primarily involved in exchange-traded or OTC derivatives activities. The framework also includes a variety of information on credit risk, taking into account counterparty credit quality as well as the availability of collateral and guarantees. Finally, the framework provides information on non-performing derivatives contracts and actual credit losses on these instruments.

Annex 4 of the Supervisory Information Framework paper presents definitions for the concepts used in the common minimum framework. For institutions that base their disclosures on the type of information contained in the common minimum framework, Annex 4 provides a basis for greater clarity and comparability of these disclosures. For example, for basic disclosures of information such as replacement cost, it should be clear to the financial statement user whether or not this information takes account of legally enforceable bilateral netting agreements.

Institutions that have developed alternative, more sophisticated internal methodologies for the type of information contained in the common minimum framework could base their public disclosures on these methods. For example, some institutions have developed simulation models for measuring potential credit exposure, which may produce

more precise estimates of exposure than the add-ons approach of the Basle Capital Accord included in the common minimum framework. Furthermore, where material, institutions are encouraged to consider disclosing additional summary information about credit and liquidity risks (such as information on credit concentrations and funding risk). The "catalogue" section of the Supervisory Information Framework paper, issued in May 1995 and the risk management guidelines released by the Basle Committee and the IOSCO Technical Committee in July 1994 discuss meaningful information that could be presented in annual report disclosures.

(2) Market risk

Currently, institutions employ a wide range of techniques to measure and manage their exposure to market risks, including value-at-risk methodologies, duration or gap analysis and scenario analysis. However, more and more large banks and securities firms are measuring and managing their market risk exposure based on a value-at-risk approach, which involves the assessment of potential losses due to adverse movements in market rates and prices of a specified probability over a defined holding period.

Given the diversity and rapid evolution of measurement and risk management techniques in the area of market risk, it does not now seem desirable to recommend a uniform approach for market risk disclosures. Instead and as argued in the Fisher report, institutions should provide summary quantitative information on their exposure to market risk based on the methods they use for internal risk measurement purposes, together with information on their actual performance in managing these risks. The guidelines for managing the risks of derivatives, released by the two Committees in July 1994, stressed that dealer banks and securities firms should produce daily information on profits and losses on their trading activities for internal risk management purposes. Institutions are encouraged to draw from this internally-generated information for public disclosure purposes. Moreover, daily profit and loss disclosures should be combined with the corresponding daily value-at-risk numbers. The Fisher report provides a detailed discussion, including a series of illustrative examples, on how institutions could disclose such quantitative, performance-based information on market risks.

Quantitative disclosures should be supplemented with information on the major assumptions and parameters necessary to understanding an institution's market risk disclosures. For example, in the case of market risk disclosures based on value-at-risk measures, institutions could specify the type of model used (variance/covariance, historical simulation, etc.), the portfolios covered by the model, as well as information on the model's parameters such as the holding period, confidence level and the observation period.

(3) Earnings

Institutions are encouraged to disclose information on how trading activities (derivatives and cash positions) affect earnings, as well as information on the earnings impact

of non-trading derivatives activities. As with market risk information, the Committees encourage institutions to base these disclosures on their internal measurement and accounting systems. The Committees recognise that accounting standards and valuation techniques differ across member countries and that earnings disclosures are therefore not directly comparable at the international level. This makes it all the more important for institutions to provide additional qualitative information explaining the accounting and valuation techniques used in the financial statements (see qualitative section above).

For additional guidance on the type of earnings information that institutions could disclose, the Committees recommend that institutions refer to the "catalogue" section of the Supervisory Framework paper, which includes discussion of the following types of information:

- Revenues from trading activities: a summary of trading revenues, for cash and derivatives instruments combined, broken down by major risk category (interest rate, foreign exchange, equities, commodities and other). Alternatively, institutions could provide a breakdown by major product trading desk (i.e. bonds, swaps, foreign exchange, equities, etc.).
- Non-trading derivatives holdings: quantitative information about the effect on earnings of off-balance-sheet positions held by the organisation to manage interest rate risk, currency risk and other risks. This information provides insight into how derivatives are being used to manage non-trading risks (for example, exposure to interest rate risk) and the degree to which these efforts have been successful.
- Unrealised or deferred losses: for derivatives that are accounted for on a historical cost basis, summary information on the notional amounts, market values and unrealised losses on these instruments. In addition, information on the amount of realised losses on derivatives positions that have been deferred and the timing of their future recognition in the profit and loss account. This information provides insight into how future earnings and capital may be affected by losses that have not yet been realised or that have been deferred.
- Derivatives valuation reserves and actual credit losses: information on the valuation reserves that an institution has established for derivatives activities, together with information on any material credit losses on derivatives instruments experienced during the period covered by the financial disclosures.