

Best Practices for Credit Risk Disclosure

Basel Committee on Banking Supervision

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Best Practices for Credit Risk Disclosure

Executive Summary

This paper provides guidance on best practices for public disclosure of credit risk in banking institutions. The objective is to encourage banks to provide market participants and the public with the information they need to make meaningful assessments of a bank's credit risk profile. Transparency in this area is particularly important since weak credit risk management practices and poor credit quality continue to be a dominant cause of bank failures and banking crises worldwide.

The issuance of this paper is a component of the Basel Committee's ongoing efforts to promote adequate transparency and effective market discipline. As discussed in its report on *Enhancing Bank Transparency*, well-informed investors, depositors, creditors and other bank counterparties can provide a bank with strong incentives to maintain sound risk management systems and internal controls and to conduct its business in a manner that is both prudent and consistent with stated business objectives. Also, transparency strengthens confidence in the banking system by reducing the uncertainty in the assessment of banks. Therefore, the Basel Committee considers the transparency of banks' activities and the risks inherent in those activities to be a key element of an effectively supervised, safe and sound banking system. The Basel Committee coordinates its efforts with the work undertaken in other groups to address the need for transparency of financial institutions' activities and risks, including the work being carried out by the Committee on the Global Financial System.

The best practices guidance discussed in this paper forms an integral part of the Basel Committee's work to provide comprehensive guidance addressing the credit risk in banking activities. In parallel with this paper, the Committee is presenting a report with sound practices guidance on credit risk management in banks. Also, the Basel Committee has issued a paper with sound practices guidance for loan accounting and disclosure. The best practices guidance in this paper complements the recommendations in the loan accounting paper in that it focuses on credit risk not only in lending activities, but also in all other types of banking activities, including trading, investments, liquidity / funding management and asset management. The table annexed to this paper compares the credit risk disclosure guidance in this paper with that of the loan accounting paper.

The best practices guidance contained in this paper is based on the current disclosure practices in various countries and on the information needs of market analysts and other information users. The Committee undertook fact-finding surveys, including interviews with a wide range of information users and surveys of actual disclosure practices, to identify gaps in current credit risk disclosure practices and form the basis for the recommendations contained in this paper. The guidance encompasses five broad areas of information critical to an assessment of a bank's credit risk profile: accounting policies and practices; credit risk management; credit exposures; credit quality; and earnings.

The Basel Committee recognises that each bank's specific disclosures will vary in scope and content according to its level and type of activities. Therefore, it may not be necessary for a bank to provide all the disclosures discussed in the paper, if particular information is not material for an external assessment of the bank. Nevertheless, all banks are expected to

provide sufficient, timely, and detailed information that allows market participants to make meaningful assessments of the bank's credit risk profile.

Apart from providing best practices for credit risk disclosure, the paper also discusses related supervisory information needs and the types of information supervisors collect on credit risk.

This paper was originally published for consultation in July 1999. The Committee is grateful to the numerous central banks, supervisory authorities, banking associations, institutions and academics that provided comments. These comments provided helpful suggestions for improvements to this final version of the paper.

Best Practices for Credit Risk Disclosure

I. General remarks

1. Introduction

1. This paper, issued by the Basel Committee on Banking Supervision¹ (Basel Committee), presents guidance on best practices for public disclosure of credit risk in banking institutions and discusses related supervisory information needs. This initiative forms part of the Committee's continuing work to promote satisfactory bank transparency and strong market discipline by encouraging banks to provide market participants and the public with the information needed to make accurate assessments of a bank's financial position and performance, business activities and risk exposures. The paper builds on concepts developed in the Basel Committee's report on *Enhancing Bank Transparency*² by providing more detailed guidance in the area of credit risk.

2. The work in this field complements and reinforces other supervisory efforts to foster safe and sound banks and stable banking systems worldwide. Meaningful and accurate disclosures facilitate market discipline and improved public scrutiny, which in turn can provide a bank with strong incentives to conduct its business in a safe, sound and efficient manner; to conform with stated business objectives; and to maintain sound risk management practices and internal controls.³

3. Following the release of its paper on *Enhancing Bank Transparency*, the Basel Committee has sought to identify gaps in credit risk disclosure practices. To this end, it has conducted a number of fact-finding surveys, including interviews with a wide range of information users (e.g., rating agencies and market analysts) and surveys of actual disclosure practices in various countries. The results demonstrate that there is a clear demand for accurate information on credit risk and that there are important gaps in currently disclosed information. These gaps include information on credit derivatives, securitisations, internal credit risk ratings, and segment information in the areas of business line, counterparty and geographic distribution. The publication of this best practices guidance paper reflects an effort by the Basel Committee to fill those gaps by encouraging disclosures that provide increased transparency and comparability.

¹ The Basel 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, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Its current chairman is Mr William J McDonough, President of the Federal Reserve Bank of New York. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

² This report discusses the role of disclosure and transparency in fostering safe and sound banking systems and presents general guidance on public disclosure and supervisory information needs. It was issued by the Basel Committee in September 1998.

³ The role of public disclosure in market discipline is discussed in the *Enhancing Bank Transparency* report.

4. The Basel Committee's work in this area is consistent with the work programme adopted by the G7 Heads of State and Finance Ministers to strengthen the international financial system. This includes a proposal to address the need for transparency of private sector financial institutions. Indeed, recent events (e.g., with respect to emerging markets and highly-leveraged institutions) have demonstrated that weaknesses in the provision and use of information by financial institutions can be a major source of the development and spread of financial instability both in individual markets and in the global financial system.

5. This paper has been prepared by the Basel Committee's Transparency Group.⁴ This Group has the mission of promoting enhanced market discipline, stable and efficient markets, and effective and comprehensive supervision of banking institutions. It carries out this task by identifying issues and developing guidance on the information needed by supervisors and by market participants to assess banking activities and the risks inherent in those activities.⁵

2. Objective

6. The objective of this paper is to promote adequate and effective transparency of banks' credit risk profiles by providing guidance to banks on useful credit risk disclosures and discussing supervisory information needs with respect to credit risk in banks. The guidance covers credit risk in all types of banking activities, including lending, trading, investments, liquidity/funding management and asset management.⁶

7. The guidance provided in this paper supplements the reporting and disclosure requirements of a variety of national accounting and disclosure frameworks. It is not intended to replace or override other reporting frameworks that may be more extensive. However, accounting standard-setters, regulators and other bodies responsible for setting disclosure standards may find the document helpful as they develop improved and more harmonised public disclosure standards.

⁴ The Basel Committee's Transparency Group is chaired by Mr Jan Brockmeijer, Deputy Director, De Nederlandsche Bank, Amsterdam and a member of the Basel Committee. The group consists of supervisory experts on disclosure and reporting from the member institutions of the Basel Committee.

⁵ In addition to this paper and the *Enhancing Bank Transparency* report, the Transparency Group - in collaboration with the International Organization of Securities Commissions (IOSCO) - has prepared a report with guidance on trading and derivatives disclosures (October 1999) and a supervisory information framework on derivatives and trading activities (issued in September 1998). Moreover and also jointly with IOSCO, it has prepared survey reports on the trading and derivatives disclosures of major banks and securities firms in the G10 countries (the most recent survey report was issued in December 1999). The Group was also involved in the preparation of the disclosure recommendations in the Basel Committee's report *Sound Practices for Loan Accounting and Disclosure*, issued in July 1999. The Group was involved in the development of the third Pillar (market discipline) in the consultative paper *A New Capital Adequacy Framework*, issued by the Basel Committee in June 1999 and a further consultation *A New Capital Adequacy Framework: Pillar Three - Market Discipline* published in January 2000.

⁶ These recommendations are consistent with and supplement the recommendations for public disclosures relating to lending activities presented in the Basel Committee's report *Sound Practices for Loan Accounting and Disclosure*, which was issued in July 1999. The Annex matches the best practices guidance in this paper with the recommendations in the loan accounting paper. This credit risk disclosure paper differs from the loan accounting paper in that the disclosure guidance focuses on not only credit risk in lending activities, but also all other sources of credit risk in banking activities, e.g., trading, investment, liquidity/funding management and asset management.

3. Contents of the report

8. Section II discusses the nature and measurement of credit risk and the importance of achieving transparency of credit risks in banks. Section III provides best practices guidance on credit risk disclosures in five broad areas relating to credit risk: accounting policies and practices, credit risk management, credit exposures, credit quality, and earnings. Section IV discusses supervisory information needs.

II. Transparency in the context of credit risk

9. Credit risk arises because bank borrowers and other counterparties may not be willing or able to fulfil their contractual obligations. This concept and the features of a sound credit risk management process are discussed in the Basel Committee's paper on principles for the assessment of a bank's management of credit risk,⁷ which is being issued simultaneously with this paper. In particular, that paper addresses the following areas: (1) establishing an appropriate credit risk environment; (2) operating under a sound credit-granting process; (3) maintaining an appropriate credit administration, measurement and monitoring process; and (4) ensuring adequate controls over credit risk.

10. The *Enhancing Bank Transparency* Report discusses the need for transparency of banking activities and the risks inherent in those activities, including credit risk. In particular, meaningful and accurate information disclosed in a timely manner provides an important foundation for market discipline and public scrutiny of banks. Risk-aware bank counterparties, in their transactions with banks, can reinforce banking supervision by rewarding institutions that manage risks effectively and penalising those whose risk management is weak or ineffective. This can provide banks with strong incentives to maintain sound risk management systems and internal controls and to conduct their activities and risk exposures in a manner that is both prudent and consistent with stated business objectives.

11. The *Enhancing Bank Transparency* Report also discusses qualitative characteristics of information that provides transparency. Drawing on the concepts discussed in that paper, credit risk information should be:

- *Relevant and timely.* Information should be provided with sufficient frequency and timeliness to give a meaningful picture of the institution's financial position and prospects. For instance, credit exposures in trading activities may deserve more frequent reporting than credit exposures in traditional banking activities, such as lending, since the variability of the portfolio composition typically is higher in the trading book. Nevertheless, complex or innovative credit risk transactions, e.g., credit derivatives, may require more frequent reporting also when entered into for other purposes than trading. To be relevant, information should also keep pace with financial innovation and developments in credit risk management techniques, e.g., credit risk modelling.

⁷ *Principles for the Management of Credit Risk*, issued by the Basel Committee in September 2000.

- *Reliable.* Information should also be reliable. Typically, it is more difficult to obtain precise measurements of credit risk than market risk. This is because the estimation of default probabilities and recovery rates usually is less exact than the measurement of price movements on liquid markets. This is in turn due to such factors as lack of and limitations in statistical data, the illiquid and long-term nature of many credit exposures, and the need to take account of bankruptcy rules and the interpretation and enforceability of those rules. This implies that information on credit risk should include a reasonable degree of caution and reflect realistic and prudent measurements.
- *Comparable.* Market participants and other users need information that can be compared across institutions and countries, and over time. Differences in the measurement of credit exposures and the establishment of credit loss allowances across countries, as well as the need to apply a degree of judgement in making those determinations, make comparable disclosures in the area of credit risk particularly important. It is also important that banks use comparable terminology, e.g., for impaired, non-performing and past-due assets.
- *Material.* Disclosures should be adapted to the size and nature of an institution's activities in accordance with the concept of materiality. Information is material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Banks' financial reports should present each material item separately. This implies that larger, internationally active banks with complex operations would be expected to provide much more information than smaller and medium-sized domestic banks with simpler business activities.
- *Comprehensive.* To enable market participants and other users of information to make meaningful evaluations of banks, information should be comprehensive. This often implies the aggregation, consolidation and assessment of information across a number of activities and legal entities.
- *Non-proprietary.* Whilst it is important that information which fulfils the criteria described above is disclosed, it is not intended that banks should disclose proprietary information. Proprietary information encompasses information (for example on customers, products or systems), the sharing of which with competitors would render a bank's investment in these products/systems less valuable, and hence would undermine its competitive position. Notwithstanding this, we do not expect the concept of 'proprietary information' to be used by banks to withhold useful information and so form an impediment to transparency. The presumption against disclosing proprietary information is not intended to allow an institution to avoid disclosing information which would disadvantage it in the market because the information reflects an unfavourable risk profile.

III. Disclosure recommendations

12. The Basel Committee recommends that banks provide timely information that allows market participants to assess the credit risk profile of banking institutions. The recommendations in this paper build on the earlier work of the Committee and include

additional, more specific guidance in several key areas.⁸ The Committee has identified the following five broad areas in which banks should provide more detailed disclosures:

- Accounting policies and practices;
- Credit risk management;
- Credit exposures;
- Credit quality;
- Earnings.

13. While each bank's specific disclosures will vary in scope and content according to its level and type of activities, all banks should provide sufficient timely and detailed information so as to allow market participants to develop a full and accurate picture of the bank's credit risk profile. Further, a bank's disclosures should be consistent with the information the bank generates and uses internally to measure, manage and monitor credit risk; accordingly, as management information systems and management reporting continue to evolve and improve, the timeliness and extent of disclosures should improve.

1. Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept.

14. All of the disclosure best practices identified in this section should be applied in line with the materiality principle (discussed in the *Enhancing Bank Transparency* report and outlined above⁹). Thus, an institution may not necessarily provide all the disclosures recommended below if a particular disclosure item is not relevant to the assessment of the bank. On the other hand, banks relying on capital markets and larger institutions with complex operations, such as those with significant international operations, would generally be expected to make more extensive disclosures.

15. Institutions are encouraged to provide as much of the information listed below as possible in audited financial statements, i.e., primary financial statements and supporting notes. In particular, disclosure of accounting policies should be in the audited part of the financial report. Information on risk management and control policies may be disclosed in the unaudited part of the financial report, e.g., in management's discussion and analysis.

⁸ This earlier work includes the following publications: *Enhancing Bank Transparency*, September 1998; *Sound Practices for Loan Accounting and Disclosure*, July 1999; *Recommendations on Public Disclosures of Trading and Derivatives Activities of Banks and Securities Firms*, October 1999; *Survey of Trading and Derivatives Disclosures of Banks and Securities Firms*, December 1999.

⁹ *Enhancing Bank Transparency*, September 1998, para. 61 and outlined in para.11 above

(a) Accounting policies and practices**2. A bank should disclose information about the accounting policies, practices and methods it uses to account for its credit risk exposures.**

16. A bank should provide information on its accounting policies and practices in each relevant area where credit exposures arise, including lending, trading, investments, liquidity/funding management and asset management (e.g., fiduciary) activities. Such information should also encompass the policies and methods used in accounting for and determining impairment of credit exposures. The disclosure should describe any changes in accounting policy from previous years.

17. Disclosures of accounting policies should cover:

- the basis of measurement for assets at initial recognition and subsequent periods, e.g., fair value or historical cost, including (as applicable) assets held for sale and assets held to maturity;
- the treatment of securitisation transactions and other activities that shift or reallocate credit risk;
- the method of recognising income on unimpaired assets, including interest recognition, the recognition of premiums or discounts on assets acquired from third parties, and treatment of fees and expenses;
- the basis of measurement for impaired assets, including how and when the bank determines an asset is impaired;
- the basis for determining when assets are considered past-due and/or impaired for accounting and disclosure purposes (number of days in arrears where appropriate);
- the basis for charging off assets;
- the method of recognising income on impaired assets, including interest recognition and when interest ceases to be accrued; and
- the treatment of hedging relationships affecting the measurement of assets.

3. A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.

18. A bank should provide comprehensive information on the accounting policies and methods it uses in determining allowances. Such information should include a description of the types of allowances and the key assumptions used in determining allowances. In addition, banks should include information, if applicable, on:

- the types of credit exposures that are evaluated individually and the types of exposures that are evaluated as a group;

- how the allocated and (any) unallocated portions of the allowances are determined;
- how the bank has incorporated historical default experience for different asset categories, current conditions, changes in portfolio composition and trends in delinquencies and recoveries;
- self-correcting mechanisms that are used to reduce differences between estimated and actual observed losses (if any);
- policies and practices for country or sovereign risk provisioning;
- other relevant factors, such as the existence and effect of concentrations of credit and changes in the level of concentrations, changes in the operating environment of borrowers and counterparties;
- changes in policies and procedures, including underwriting standards and collection and recovery practices; and
- how the level of allowances compare with historical net loss experience.

19. Banks should explain the reasons for changes in the elements and components of the allowances, so that a financial statement reader can understand how changes in risks in the portfolio relate to the allowances established at the end of the period. For instance, it may be appropriate to discuss how changes in estimation methods and assumptions affected the allowances; why reallocations of the allowance among different parts of the portfolio or different elements of the allowance occurred; and how actual changes and expected trends in non-performing credit exposures affected the allowances.

(b) Credit risk management

4. *A bank should disclose qualitative information about the nature of credit risk in its activities and describe how credit risk arises in those activities.*

20. A bank should provide sufficient qualitative description about credit risk to enable the users of financial statements to understand how it defines credit risk and the business activities that generate credit risk.

5. *A bank should disclose information on the management, structure and organisation of its credit risk management function.*

21. A bank should disclose information that describes the structure of its credit risk management function, including information on the management of the function, segregation of duties, and committees or other management infrastructure. Management should specifically address the loan review function and related internal controls. Such disclosures should be placed in context with the overall risk management structure of the organisation, and changes in the structure from prior period disclosures should be discussed.

6. *A bank should disclose qualitative information on its credit risk management and control policies and practices.*

22. A bank should disclose information on its strategies, objectives, and practices in managing and controlling its credit risk exposures. Specifically, an institution should summarise its policies for identifying, measuring, and managing credit risk on both an individual counterparty and portfolio basis. Such disclosures should include information, if applicable, on:

- the methods used to limit or control overall credit exposures, including
 - risk limits, (e.g., counterparty, pre-settlement, settlement);
 - limits on concentrations of credit to single counterparties or classes of borrower; and
 - limit monitoring.
- the process and methods used to assess credit exposures on both an individual counterparty and portfolio basis, including a description of the internal credit rating classification system (e.g., what each rating means in terms of default probability, degrees of risk being distinguished, performance over time and ex-post evaluation);¹⁰
- the mechanisms used to reduce and/or mitigate credit exposures, such as collateral, guarantees, covenants, bilateral and multilateral netting arrangements, and early termination agreements;
- securitisation activities; and,
- the use of new or innovative instruments that transfer credit exposure, such as credit derivatives.

23. If an institution stress-tests its counterparty credit exposures, it should disclose its process for stress testing, and how testing is incorporated into its credit risk management system.

7. *A bank should disclose information on its techniques and methods for managing past due and impaired assets.*

24. A bank should discuss the techniques it uses to monitor and manage past due or impaired assets/credit relationships, including its procedures for credit quality classifications

¹⁰ See also recommendation 18.

and its practices and procedures for evaluating the adequacy of credit loss provisions and credit loss allowances.¹¹

8. *A bank should provide information on its use of credit scoring and portfolio credit risk measurement models.*

25. In addition to methods currently used by banks to assess credit risk exposures, some banks are exploring new approaches to measuring exposure to credit risk, including various modelling techniques. A bank that uses credit scoring or portfolio credit risk measurement models to manage credit risk should provide qualitative and quantitative information about these approaches. Information that should be provided includes:

- whether credit scoring or credit risk measurement models are used and, if so, descriptive information about the types of models, portfolio[s] covered and size of portfolio[s];
- quantitative and qualitative information about the credit risk measurement models used, including model parameters (e.g., holding period, observation period, confidence interval, etc.), performance over time, model validation and stress testing information.

Banks that do not use credit models should ensure that they disclose sufficient qualitative and quantitative information to provide comparable information on the management of credit risk.

(c) Credit exposures

9. *A bank should disclose balances of credit exposures, including current exposure and, where applicable, future potential exposure, by major categories.*

26. A bank should provide information on its total credit exposures, including exposures arising from lending, trading, investment, liquidity/funding management and off-balance-sheet activities. Such information should include current exposures (as of the financial report date) and, where appropriate, future potential exposures. In addition, maturity breakdowns should be provided (e.g., under 1 year, 1 – 5 years, 5 – 10 years, 10 – 20 years, and 20 and over years), as well as average balances for the period.

¹¹ Some accountants consider the use of the terms “provision” and “reserve” inappropriate when referring to accumulated value adjustments of loan assets and prefer other descriptions, e.g., “allowance”. For instance, the International Accounting Standards Committee defines a provision as a type of liability, while a reserve is defined as a component of equity (*IASC Framework for the Preparation and Presentation of Financial Statements*).

(i) Segment disclosures*Business line information***10. A bank should disclose information about credit exposures by business line.**

27. A bank should disclose credit exposure information by business line or type of exposure, such as commercial, industrial sector, real estate, construction, credit cards, leasing, and residential mortgage.

*Counterparty information***11. A bank should disclose information about credit exposures by major categories of counterparties.**

28. A bank should disclose information about the composition of its on- and off-balance sheet credit exposures by major types of counterparty, including foreign government, domestic government, foreign corporate, domestic corporate, consumer, and other financial institutions. It should provide this information without taking account of the effects of credit risk mitigation techniques, e.g., collateral and netting, which are the subject of a separate disclosure recommendation below. In addition, intra-group transactions and exposures to related parties, directors and shareholders should be separately identified and the methods used to value these transactions should be described. High-risk counterparties, e.g., highly leveraged institutions, should be separately disclosed¹².

*Geographic information***12. A bank should disclose information about credit exposures by geographic areas.**

29. A bank should disclose summary information about the geographical distribution of its credit exposures, including its domestic and international credit exposures showing sovereign exposures and other cross-border exposures. Geographic areas may comprise individual countries or groups of countries or regions within countries. A bank should also disclose how loans are allocated to geographic areas (e.g., domicile of counterparty).

(ii) Concentration information**13. A bank should disclose information about significant concentrations of credit risk.**

30. A bank should disclose its policies and methods for determining concentrations of credit risk, what it considers to be a “significant” concentration, and for each concentration disclose a description of the shared characteristics that identify the concentration as well as the magnitude of the credit exposure. These disclosures should be designed in a way that is consistent with any confidentiality requirements. Significant concentrations of credit risk can

¹² The characteristics of an ‘HLI’ are set out in ‘Banks’ interactions with Highly Leveraged Institutions’ January 1999.

arise in relation to individual borrowers or counterparties, related borrowers or groups of borrowers, particular economic sectors or particular countries or regions.

(iii) Credit risk mitigation techniques

14. A bank should disclose the effect of credit risk mitigation techniques, including collateral, guarantees, credit insurance and legally enforceable netting agreements.

31. A bank should disclose quantitative information about the effect of credit enhancements on their counterparty credit exposure. This information should include the effect of legally enforceable bilateral and multilateral netting agreements. If the institution uses collateral, covenants, guarantees or credit insurance to reduce credit exposure, the impact on credit exposure should be disclosed. If appropriate, such disclosures may include the nominal and market value of the collateral provided.¹³

15. A bank should disclose quantitative and qualitative information about its use of credit derivatives and other instruments that reallocate credit risk.

32. The development of innovative tools and techniques to manage credit risk continues to evolve and some banks are currently using new credit risk management instruments such as credit derivatives. As new practices and instruments to manage credit exposures are developed, banks should provide both quantitative and qualitative information about these new practices and instruments. For those banks that currently use such innovative instruments, disclosures should include the following information:

- discussion of how instruments are used, including strategy and objectives;
- notional amounts and fair value of instruments;
- amount of credit risk bought and/or sold;
- breakdown by type of instrument (e.g., total return swap, credit default swap, or other credit derivatives) and,
- where instruments are recorded (i.e., trading vs. banking book).

16. A bank should disclose quantitative and qualitative information about its securitisation activities.

33. A bank that securitises assets should disclose both qualitative and quantitative information about these activities. Such information should include the bank's strategy and objectives for its securitisation activities; the amount and types of assets securitised; and the

¹³ Banks are also encouraged to provide information about assets that they themselves have pledged for their own liabilities or commitments.

amount of servicing retained. It should also disclose the amount of risk or assets retained; details on subordinated interests retained (first loss protection); and general recourse provisions. If the bank has a continuing interest in securitised assets, the performance of those securitised assets should be disclosed.

17. A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.

34. A bank should disclose information about recourse transactions – transactions where it has sold the asset[s] but retains responsibility for payment if the original borrower[s] or counterparty defaults or fails to fulfil other contractual or implied obligations. Disclosures should include summary information about the terms of recourse arrangements and the amount of assets sold and expected losses under such arrangements. These arrangements may expose a bank to significant credit risk, but are often not recognised on the balance sheet.

(d) Credit quality

18. A bank should provide summary information about its internal rating process and the internal credit ratings of its credit exposures.

35. A bank should provide summary information about its internal rating processes, and explain the loss concept used and how internal ratings are used in the bank's internal capital allocation process. Based on its internal credit rating processes, a bank should provide summary information on the quality of its on- and off-balance sheet credit exposures. Such a disclosure might include a discussion of counterparty type and internal credit rating. A bank may also disclose information about credit exposures based on external ratings. Banks would not be expected to disclose proprietary information.

19. A bank should disclose total credit exposures by major asset category showing impaired and past due amounts relating to each category.

36. A bank should provide comprehensive information on impaired and past due assets, including breakdowns by relevant asset category, counterparty type and geographic area. Such information should include separate disclosures of impaired and past-due assets (e.g., 90 days or more) and an ageing analysis of past due credit exposures.

20. A bank should disclose the amounts of specific, general and other allowances. Where applicable, these allowances should be disclosed by major asset category.

37. A bank should disclose the amounts of all allowances. Where applicable, these should be disclosed by the major asset categories described above (e.g., allowances for loan losses, allowances related to off-balance-sheet exposures, etc.).

21. A bank should disclose a reconciliation of changes in the allowances for credit impairment.

38. A bank should provide a reconciliation of activity for any allowances established for credit impairment (“continuity schedule”), including:

- a description of the type of allowance;
- the opening balance of the allowance;
- charge-offs (or write-offs) taken against the allowance during the period;
- recoveries of previous charge-offs added back to the allowance during the period;
- amounts set aside for estimated probable losses during the period;
- any other adjustments to the allowance (e.g., exchange rate differences, etc.), including transfers among allowances; and,
- the closing balance of the allowance.

39. Charge-offs and recoveries that have been recorded directly in the income statement should also be disclosed.

22. A bank should disclose credit exposures on which the accrual of interest or other contractual cash flows – in accordance with the terms of the original agreement – has ceased because of deterioration in credit quality.

40. A bank should disclose information about the balances of credit exposures where the accrual of interest or other contractual cash flows (e.g., cash flows on swap transactions) has ceased as a result of deterioration in credit quality. Such disclosures should provide a breakdown of the type of credit exposure, the amount of exposure and its impact on the income statement.

23. A bank should disclose summary information about credit exposures that have been restructured during the year.

41. A bank should disclose aggregate information about credit arrangements that have been restructured during the period. Such information should include the balance of the restructured loans, the magnitude of the restructuring activity, the impact of restructured credit arrangements on allowances and the present and future earnings, and the basic nature of concessions on all credit relationships that are restructured, including loans, derivatives and other on- and off-balance sheet activities. If full repayment is expected, the restructured credit

need not be disclosed after performance for a reasonable period in accordance with the modified terms.¹⁴

(e) Earnings

24. A bank should provide information on revenues, net earnings and return on assets.

42. In order to adequately assess a bank's financial performance and, specifically, what it is earning relative to its credit risk exposures, a bank should provide a comprehensive earnings statement and analysis, including a breakdown of income and expenses (including extraordinary items) for the period. Additional details should include:

- income and expense information grouped by nature or function within the bank;
- interest income and expenses by (as relevant) type of activity (e.g., lending, trading, investing, etc.), geographical distribution and credit quality;
- information on the impact of non-accrual and impaired assets on the financial performance of the bank including information on charge-offs and provisions;
- summary information on the effect of hedging activities on income and expenses;
- the amount of any charge-offs and recoveries that have been recorded directly in the income statement; and
- the income effect of securitisations.

IV. Supervisory information needs on credit risk

43. Supervisors use a combination of methods to collect information, depending on their supervisory practices, the nature of the data, the number of institutions under review, their size and complexity, and the characteristics of the market and regulatory framework. It is essential that banking supervisors are able to obtain information that permits them to detect potential problems at an early stage and identify trends not only for particular institutions, but also for the banking system as a whole.

44. Public reporting, including information in annual reports, press releases and analysts' reviews, is one element of the information used by supervisors. The recommendations included in Section III of this paper outline a number of specific disclosures that a bank should include in its public reporting to enhance the transparency of its credit risk profile.

¹⁴ In some countries, a period of six months may reflect a reasonable period of resumed borrower repayments of contractual principal and interest.

Many supervisors may use such public disclosures as a part of the information they collect to assess the credit risk profile of individual banking institutions, as well as the banking system.

45. To obtain a timely and comprehensive picture of credit risk in supervised banks, however, supervisors need information in addition to that publicly disclosed. Additional information requested or obtained by supervisors through either supervisory reporting or otherwise may include:

- detailed information on credit exposures to large borrowers/counterparties or to borrowers in particular sectors of the economy, including borrower identity, type of exposure and amount of exposure;
- detailed information on specific borrowers/counterparties included on the bank's "watch" list;
- detailed information on specific borrowers/counterparties currently considered impaired, including any credit loss allowances currently allocated to or identified for the exposure;
- detailed information on restructured credits and credits for which special conditions have been granted; and
- similar information to that publicly disclosed, but on a more frequent and/or current basis.

46. In many countries, bank supervisors rely heavily on information provided in regular supervisory reporting by banking institutions. This information is collected and analysed to assess the condition, performance and risk profile of individual banks, the banking system, or particular sectors of the economy. Supervisory reporting systems provide for early detection in the intervals between on-site examinations, external audits, or supervisory visitation, enabling supervisors to take prompt action before problems become more serious.

47. To complement the information available in public and supervisory reporting, supervisors often collect additional information to assist in clarifying a bank's credit risk profile, as well as to better understand important credit risk management issues. Supervisors collect data during on-site examinations, targeted examinations, external audit processes, and special studies or surveys. This "first-hand" information is used together with public disclosures and regular supervisory reporting to obtain a more comprehensive picture of the bank's condition, operations, risk profile and risk management activities. Internal management information considered most relevant for credit risk includes:

- broad credit risk management information, including asset quality figures;
- internal control/internal audit statistics and other measures;
- trend and sector analyses;
- performance measures relating actual results to expected performance; and,
- economic capital allocated to credit risk and returns on this capital.

48. Where institutions undertake business activities that fall under the jurisdiction of different supervisors, or where certain affiliates are not supervised, supervisors should consider how best to obtain information that provides a comprehensive, timely picture of the risks associated with the institutions' overall activities. Supervisors may, for example, find it useful to discuss this issue with regulated firms. Bank supervisors should attempt to obtain information about these activities on a consolidated basis, while recognising the legal distinctions among subsidiaries and the need to receive summary information about major business activities and key entities within a consolidated banking group.

V. Conclusions

49. Experience from around the world indicates that poor credit quality coupled with weak credit risk management practices continues to be a dominant factor in bank failures and banking crises. Therefore, it is clear that information on banks' credit risk profiles, including the quality of their credit exposures and the adequacy of their credit risk management processes, is crucial in market participants' and supervisors' assessment of their condition, performance and ability to survive in the long-run. Such information is also important in assessments of the overall safety and soundness in banking systems.

50. The Basel Committee has identified the following five broad areas in which banks should provide comprehensive and accurate disclosures:

- Accounting policies and practices;
- Credit risk management;
- Credit exposures;
- Credit quality;
- Earnings.

51. At present, not all banks comply with the best practices guidance presented in this paper. The Basel Committee recommends that banks increase their level of public disclosure to comply with this guidance in line with the nature, size and complexity of their activities. Through surveys and other fact-finding initiatives, the Basel Committee will continue to monitor the extent to which banks are making progress in enhancing their credit risk disclosures.

Annex

Credit risk disclosure guidance comparison

To help readers compare the disclosure guidance provided in this paper with the disclosure recommendations issued by the Basel Committee in July 1999 as part of its paper on loan accounting, the table below matches these two sets of recommendations. As an additional assistance, the table also references similar disclosure requirements in International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC).

<i>Best practices recommendation in this paper</i>	<i>Recommendations in the Loan Accounting Paper, July 1999 (LAP)</i>	<i>International Accounting Standards (IAS)</i>
1. Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept	LAP 12	IAS 1.29, IAS 30, Framework
2. A bank should disclose information about the accounting policies, practices and methods it uses to account for its credit risk exposures	Similar to LAP 13, although broader in scope	IAS 1.97, IAS 30.43, IAS 32.47
3. A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses	LAP 14	(IAS 1.97, IAS 30.43, IAS 32.47)
4. A bank should disclose qualitative information about the nature of credit risk in its activities and describe how credit risk arises in those activities		
5. A bank should disclose information on the management, structure and organisation of its credit risk management function	Expanded guidance on certain elements of LAP 15	
6. A bank should disclose qualitative information on its credit risk management and control policies and practices	LAP 15	IAS 32.43A (as amended by IAS 39)
7. A bank should disclose information on its techniques and methods for managing past due and impaired assets		
8. A bank should provide information on its use of credit scoring and portfolio credit risk measurement models		
9. A bank should disclose balances of credit exposures, including current exposure and, where applicable, future potential exposure, by major categories		Expanded guidance in comparison with IAS 32.66

<i>Best practices recommendation in this paper</i>	<i>Recommendations in the Loan Accounting Paper, July 1999 (LAP)</i>	<i>International Accounting Standards (IAS)</i>
10. A bank should disclose information about credit exposures by business line		(IAS 14)
11. A bank should disclose information about credit exposures by major categories of counterparties	Similar to LAP 16, although broader in scope	
12. A bank should disclose information about credit exposures by geographic areas	Similar to LAP 17, although broader in scope	(IAS 14)
13. A bank should disclose information about significant concentrations of credit risk	LAP 18	IAS 32.66 (b), IAS 30.40
14. A bank should disclose the effect of credit risk mitigation techniques, including collateral, guarantees, credit insurance and legally enforceable netting agreements		
15. A bank should disclose quantitative and qualitative information about its use of credit derivatives and other instruments that reallocate credit risk		
16. A bank should disclose quantitative and qualitative information about its securitisation activities		IAS 39.170 (d)
17. A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements	LAP 19	(IAS 30.26, IAS 37.86)
18. A bank should provide summary information about its internal rating process and the internal credit ratings of its credit exposures		
19. A bank should disclose total credit exposures by major asset category showing impaired and past due amounts relating to each category	Includes elements of LAP 20 and 21, although broader in scope	
20. A bank should disclose the amounts of specific, general and other allowances. Where applicable, these allowances should be disclosed by major asset category	Includes elements of LAP 20, although broader in scope	Expanded guidance in comparison with IAS 30.43 (c)
21. A bank should disclose a reconciliation of changes in the allowances for credit impairment	Similar to LAP 22, although broader in scope	IAS 30.43 (b)

<i>Best practices recommendation in this paper</i>	<i>Recommendations in the Loan Accounting Paper, July 1999 (LAP)</i>	<i>International Accounting Standards (IAS)</i>
22. A bank should disclose credit exposures on which the accrual of interest or other contractual cash flows – in accordance with the terms of the original agreement – has ceased because of deterioration in credit quality	Similar to LAP 23, although broader in scope	IAS 30.43 (d)
23. A bank should disclose summary information about credit exposures that have been restructured during the year	Similar to LAP 24, although broader in scope	
24. A bank should provide information on revenues, net earnings and return on assets		IAS 1.75, IAS 30.10