BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA FACSIMILE

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

11 November 2004

Comments on ED 7 financial instruments disclosure proposal

Dear Sir David,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Draft of the proposed IFRS, *Financial Instruments: Disclosures*, published for comment in July 2004. The Committee has a strong interest in promoting sound accounting and disclosure standards that result in transparent and high quality financial statements by banks.

Please find our detailed comments in the attached note. The Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, has prepared the note. This note has been approved by the Basel Committee. The development of our comments was coordinated by an *ad hoc* subgroup on ED7 under the direction of Karl-Heinz Hillen, Head of Division Accounting and Supervisory Databases, Deutsche Bundesbank. The Basel Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+31 20 524 3360), Mr Hillen (+49 69 9566 8379), or Ms Donna Bovolaneas at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

Jaime Caruana

Attachment

Basel Committee Comments on the IASB's Exposure Draft of the Proposed IFRS "Financial Instruments: Disclosures"

Introduction

The Basel Committee on Banking Supervision[1] (Committee) has been developing and publishing comprehensive guidance and policy papers on risk reporting by banks in recent years. In the newly adopted *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, commonly referred to as Basel II, Pillar 3 – Market Discipline – represents an important outcome of the Committee's efforts to enhance capital adequacy transparency in financial markets. Pillar 3 presents a set of disclosure requirements that will allow market participants to assess key pieces of information on the capital, risk exposures, risk assessment processes, and hence the capital adequacy of banks. The Committee believes that such transparency will contribute to the soundness and stability of the financial system.

Consistent with this financial stability objective, principle 21 of the Committee's *Core Principles for effective banking supervision* (September 1997) states that banks should regularly publish financial statements that fairly reflect their condition. This principle is developed further in the Committee's September 1998 paper on *Enhancing bank transparency*. This paper identifies six broad categories of disclosure that are necessary for achieving a satisfactory level of bank transparency and ensuring effective market discipline as a complement to effective banking supervision: financial performance; financial position (including capital, solvency, liquidity); risk management strategies and practices; risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks); accounting policies; and basic business, management and corporate governance information. Recommendations for adequate disclosure of credit risk are also made within two other Committee documents: *Sound practices for loan accounting and disclosure* (July 1999), which is currently being updated in response to the recent revisions to IAS 39 *Financial Instruments: Recognition and Measurement*, and *Best practices for credit risk disclosure* (September 2000).

The importance of standards of transparency in the private sector also has been recognised by the G7 Finance Ministers and Central Bank Governors who, in a 1998 Declaration, requested the Committee and other international regulatory organisations to review the standards of the IASB's predecessor, the International Accounting Standards Committee (IASC). In its April 2000 report on the results of this review, the Committee expressed concern that IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* was an old standard that had not been updated since 1991. As a consequence, it did not reflect the latest developments in banking and failed to encompass then current best (or even good) practice in terms of disclosure, particularly in relation to risk exposures and risk management policies, as well as the sound disclosure practices identified in the Committee's policy papers. The Committee indicated in its report that it had advised the IASC that IAS 30 should be revised, and the IASC subsequently added a project to its agenda to consider the need to update this standard.

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[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, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Accordingly, the Committee welcomes the draft IFRS as the outcome of the work of the IASB and its predecessor to revise and replace IAS 30 with a standard that focuses on risk disclosures. In this regard, the Committee notes that both bodies benefited from the input and guidance provided by the Financial Activities Advisory Committee (FAAC) and its predecessor, the IAS 30 Steering Committee. We also appreciated having the ability to contribute to the work of these advisory groups through the participation of two observers who represented the Committee on these groups. We see the valuable role that the FAAC and its predecessor played in the development of the draft IFRS as evidence that the international working groups that the IASB will be setting up to assist it in tackling longer-term issues will be a successful component of its standard-setting process.

The Committee believes that enhanced disclosures of risks arising from financial instruments will allow markets to improve their evaluations of the risk profiles of banks and other financial institutions. In addition, such disclosures will enable banks to more comprehensively assess the risks of their debtors. The Committee sees this as a valuable pre-condition for strengthening the quality of banks' credit portfolios, from which the soundness and stability of the financial system will benefit. It is from this perspective that the Committee has reviewed the draft IFRS. In addition, because a large number of banking groups include insurance entities, which requires an overall supervisory assessment of the combined group, our review of the proposal has also taken these bank-headed conglomerates into account.

This note comprises two parts. The first part presents our main comments on the draft IFRS in the section below. The first part also reiterates previous Committee comments on certain aspects of the fair value option in IAS 39 *Financial Instruments: Recognition and Measurement* that have disclosure implications that the draft IFRS does not adequately cover. The second part of this note provides a number of more detailed comments on the draft IFRS and also addresses some technical issues. In both parts we have tried, to the extent possible, to consider the specific questions raised in the invitation to comment.

Part I: Main Comments

The Committee recognises that the transition from IAS 30 to the draft IFRS represents a conceptual change as the draft IFRS is not a bank-specific standard but applies to all types of entities that use financial instruments. We commend the IASB for adopting a principles-based approach in its effort to achieve the disclosure objectives set forth in the draft IFRS. Furthermore, the Committee concurs with the IASB's conclusion that disclosures about risks arising from financial instruments should be part of the financial statements because the exclusion of these disclosures would render the financial statements incomplete and potentially misleading. (Question 6)

Given the diversity of the entities to which the proposal will apply, the IASB's acknowledgement that an entity needs to decide in light of its circumstances how detailed its disclosures should be in order to satisfy the requirements of the draft IFRS is consistent with the proposal's principles-based approach. This is also in line with the principle of materiality in Pillar 3 of the Basel II framework. Moreover, many of the proposed risk disclosures in the draft IFRS are based on information provided internally to an entity's key management personnel, which is consistent with the guidance in the Committee's paper on *Enhancing Bank Transparency* and with the disclosure approach taken in Pillar 3. These elements of the proposal should prevent small and medium-sized entities from incurring undue cost when providing the required disclosures.

However, the assets, liabilities, and capital presented in the financial statements of banks consist mainly of financial instruments and banks are exposed to significant risks arising from financial instruments. Accordingly, the Committee believes that from a risk perspective the disclosure requirements in the draft IFRS should differentiate between banks and other types of entities. Therefore, our main comments address four topics: the structure of the balance sheet, the impact of the IAS 39 fair value option on the draft IFRS, capital disclosures, and the need for certain other fair value disclosures.

Structure of the balance sheet

IAS 30 requires banks and similar financial institutions to present a balance sheet that groups assets and liabilities by nature and list them in an order that reflects their relative liquidity. The categories of assets and liabilities specified in IAS 30 can be disclosed in the balance sheet itself or in the notes. IAS 1 *Presentation of Financial Statements* also requires the balance sheets of entities such as financial institutions to be structured by liquidity. In contrast, the draft IFRS requires that the balance sheet disclose the carrying amounts of financial instruments according to the classifications defined in IAS 39.

We consider the balance sheet classification approach followed in the draft IFRS to be appropriate because it recognises the significant differences in the recognition and measurement of financial instruments under IAS 39. However, in our view, the relationship between the balance sheet requirements in IAS 1 and those in paragraph 10 of the draft IFRS remains unclear. To clarify this, we would recommend that an illustrative example that addresses this relationship be included in the Implementation Guidance. The balance sheet in this illustrative example would be based on the classifications of financial instruments in IAS 39, but these classes should be further subdivided into types of instruments, e.g., loans and securities. The applicability of the illustrative example could be restricted to entities whose balance sheets are predominantly composed of financial instruments or to "banks and similar financial institutions".

Impact of the IAS 39 fair value option on the draft IFRS

We recognise that the IASB is continuing to deliberate how it will proceed with its proposed amendments to the IAS 39 fair value option. Nevertheless, as the Committee stated in its July 2004 comment letter to the IASB on these proposed amendments, it is imperative that an entity provide a high level of disclosure concerning its accounting and risk management policies and their rationale when it chooses to use the fair value option. In this regard, neither the proposed April 2004 amendments to IAS 39 for the fair value option nor paragraphs 10(a) and 21(a)(i) of the draft IFRS require identification of the categories or types of assets and liabilities (and their related fair values) subject to this option and the related gains or losses for each category reflected in the profit or loss account and in equity. As a consequence, in the absence of these disclosures, we believe that it would be difficult for users of financial statements to fully understand the impact of an entity's application of the fair value option. Furthermore, the section of the draft IFRS on Significance of Financial Instruments for Financial Position and Performance does not require an entity to explain how and why it uses the fair value option, e.g., to fulfil specific risk management objectives. If the IASB retains a fair value option in IAS 39 going forward, these disclosures should be required through amendments to the disclosure provisions of IAS 32 and, ultimately, in this draft IFRS.

In addition, we would like to reiterate the Committee's comment from its July 2004 comment letter that, if the IASB continues to allow the fair value option to be used in ways that result in the mark to market of own credit risk on financial liabilities, a new line item should be included in equity that would clearly identify the cumulative effect on equity of fair value changes attributable to changes in an entity's own credit risk.

Capital disclosures

Paragraphs 47(d) and (e) of the draft IFRS require disclosures related to an entity's compliance with the capital targets set by management and any externally imposed capital requirements not just at the reporting date, but also during the reporting period. When non-compliance has occurred during the period, but has been satisfactorily resolved by the reporting date, the Committee does not believe that disclosure of such a breach is warranted in the financial statements unless any consequences of the breach remain in effect despite its resolution. We therefore strongly recommend that the draft IFRS be revised accordingly.

The assessment of the adequacy of a bank's capital in its function as a risk buffer is one of the most important tasks of banking supervisors in most jurisdictions. The markets also pay close attention to a bank's capital adequacy. Therefore, under Pillar 3 of the Basel II framework, banks also will publish information on regulatory capital. At the same time, however, Pillar 3 focuses on the framework's industry-wide minimum capital standards and keeps any externally imposed entity-specific regulatory capital requirements that exceed the minimum standards confidential.

Paragraph BC52 of the Basis for Conclusions recognises the arguments against requiring disclosure of externally imposed entity-specific capital requirements. Paragraph BC53 then notes that the IASB decided not to require disclosure of (any) externally imposed capital requirements, but to require disclosures about an entity's compliance with such requirements and the consequences of non-compliance. In this regard, we would like to reiterate that an entity's regulator has the ultimate responsibility for determining whether a formal breach of an entity-specific capital requirement imposed by the regulator has taken place. Consequently, entities that are subject to externally imposed capital requirements would benefit from having this view clearly stated in paragraph 47. The Committee therefore recommends that the IASB add the following statement as the new final sentence of paragraph 47: "Nevertheless, when an entity is subject to externally imposed entity-specific capital requirements, the entity's regulator determines whether the entity is in compliance with these requirements or has breached these requirements".

Finally, we have serious concerns about the second Illustrative Example in paragraph IE2 of the Implementation Guidance. We find it very misleading because it may cause preparers to believe that they are obliged to disclose externally imposed entity-specific requirements that they have satisfied within the time frame specified by their regulator, thereby avoiding a breach of these requirements. We therefore strongly recommend that this example be recast so that it discloses non-compliance with the applicable industry-wide minimum capital standards at the reporting date, rather than implying that the existence of an approved plan for achieving an externally imposed entity-specific capital requirement must be disclosed. Our recommended revision of this Illustrative Example is presented in the Annex to this note.

Other fair value disclosures

Paragraphs 26-31 of the draft IFRS set forth disclosure requirements pertaining to the fair value of financial instruments. We believe that users of financial statements would benefit from the following additional disclosures related to fair value.

First, paragraph 31 requires certain disclosures about the methods and assumptions applied in determining fair values of financial assets and financial liabilities. In this regard, an entity must disclose whether fair values are determined by reference to published price quotations in an active market or are estimated using a valuation technique. The Committee's October 2002 comments on the Exposure Draft of proposed amendments to IAS 32 and IAS 39 acknowledged that this disclosure would provide useful information to financial statement users, including banking supervisors, by assisting users in making judgements about the reliability of fair values presented in an entity's financial statements. Nevertheless, the Committee continues to recommend that the IASB strengthen its fair value disclosure requirements by revising the draft IFRS to require that entities disclose quantitative information on the amount of fair values determined based on quoted prices versus the amount estimated using a valuation technique. This disclosure could be provided in the form of percentages for each class of financial assets and financial liabilities.

Second, in comparing paragraph 31(c) of the draft IFRS to paragraph 92(c) of IAS 32, we note that the IASB has changed the required disclosure of "the effect on the fair value of a range of reasonably possible alternative assumptions" (emphasis added) in the latter to the disclosure of "the effect on the fair value of those reasonably possible alternative assumptions" in the former. Because of concerns about the reliability of fair value estimates that are determined using a valuation technique based on assumptions that are not supported by observable market prices or rates, we believe the wording change in the draft IFRS may cause entities to reduce the amount of information they disclose about the possible variability in certain fair value estimates. The rationale for this potential loss of relevant information does not appear to have been addressed in the Basis for Conclusions. We would like to encourage the IASB to restore the original wording from paragraph 92(c) of IAS 32. Since this information will already have to be provided by preparers under current IAS 32, conforming paragraph 31(c) of the draft IFRS to paragraph 92(c) of IAS 32 should add no additional burden to preparers. (Question 10)

Finally, paragraph 31(b) of the draft IFRS requires the disclosure of "whether fair values of financial assets and financial liabilities are determined directly, in full or in part, by reference to published price quotations in an active market or are estimated using a valuation technique" (emphasis added). The phrase "in full or in part" also appears in paragraph 31(c). We are not sure about the intended meaning of this phrase. It might refer to individual structured products whose components are separately valued, with some based on price quotations and others based on valuation techniques. Alternatively, because the fair value disclosures mandated by paragraph 31(a) are for classes of financial instruments, the phrase might refer to these classes and whether or not the fair value of each separate class was fully determined from price quotations. We would recommend that the meaning of "in full or in part" be clarified.

Part II: Comments on other aspects of the draft IFRS and technical issues

Comments on ED 7

ED 7.4: Scope

ED 7 applies to financial instruments within the scope of IAS 39 plus some unrecognised financial instruments that are outside the scope of IAS 39. Though this formulation is consistent with IAS 32, we do not believe it is sufficiently clear to ensure that all entities will properly apply the draft IFRS. We would recommend that paragraph 4 be revised to better identify specific examples of unrecognised financial instruments that are within the scope of ED 7, and which ones are not. (Question 10)

ED 7.7: Classes of financial instruments

The draft IFRS requires certain disclosures by class of financial instruments: financial assets involved in certain transfers or other types of arrangements (paragraph 14), fair value (paragraphs 22, 26, and 28), and credit risk, allowances, and impairment (paragraphs 17, 22, 39, and 40). Paragraph 7 of the draft IFRS directs entities to group their financial assets and liabilities into classes, first based on the measurement classifications in IAS 39 and then according to the characteristics of the financial instruments in light of the nature of information disclosed. Thus, the proposal specifies two different concepts for building classes of financial instruments and disclosing information about them. Considering this second concept, we are concerned that leaving the decisions on how to build these classes entirely to an entity's discretion may reduce the comparability of financial statements. Consistent with our comments on the structure of the balance sheet in part I above, we believe banks would benefit from additional guidance on which sort of class would be most relevant for each of the different types of disclosure by class. This could be accomplished by including additional examples in the Implementation Guidance, similar to the one for credit risk disclosure in paragraph IG12 (which, however, is limited to loans and does not address other types of financial assets). (Question 10)

ED 7.11: Caption before paragraph 11

The caption that precedes paragraphs 11 and 12 refers to "Financial assets and financial liabilities at fair value through profit or loss", but these two paragraphs only address financial liabilities at fair value through profit or loss. The caption should be reworded by eliminating the reference to financial assets. (Question 10)

ED 7.13: Reclassification

Paragraph 13 requires an entity to disclose the reason for reclassifying a financial asset that has been measured at fair value to one that is measured at cost or amortised cost. We believe that disclosure of the reason for reclassifying a financial asset in the opposite direction, i.e., from cost or amortised cost to fair value, will also provide useful information and should be added to the draft IFRS. (Question 10)

ED 7.17: Disclosure concerning allowance account

We recognise that the draft IFRS contains no disclosure requirement demanding a distinction between allowances for individual impairment and those for collective impairment of financial assets measured at amortised cost. Pillar 3 of the Basel II framework is more detailed in this context. For banks and other entities that hold significant amounts of such assets, we recommend that the disclosure of such allowance information be discussed in the Implementation Guidance. (Question 1)

ED 7.21: Items of income, expense, gains and losses

Two captions precede paragraph 21 of the draft IFRS. The first refers to "income statement and equity" and the second refers to "items of income, expense, gains and losses". However, while the required disclosures in paragraph 21(b) would have to be in the notes, it is not clear which, if any, of the other disclosures required by paragraph 21 must be provided in the income statement. As noted in paragraph BC15 of the draft IFRS, paragraph 21(a) of the proposal would add a requirement to disclose income statement gains and losses by the measurement classifications in IAS 39. In our view these disclosures of gains and losses should be located within the income statement. As with our earlier comment on the structure of the balance sheet, we would recommend that an illustrative example of an income statement be included in the Implementation Guidance to clarify how paragraph 21 is to be applied. This illustrative example also could be restricted to entities whose balance sheets are predominantly composed of financial instruments or to "banks and similar financial institutions".

Paragraph 21(e) of the draft IFRS requires the disclosure of interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39. Although this disclosure was carried forward to ED 7 from paragraph 94(h)(iii) of IAS 32 (December 2003), it is different from the disclosure requirement in paragraph 170(c)(iii) of IAS 39 (revised 2000), which refers to the amount of interest income that has been accrued on impaired loans pursuant to paragraph 116 (of IAS 39 (revised 2000)) and that has not yet been received in cash. The Basis for Conclusions in IAS 32 (December 2003) does not explain why this change to the disclosure approach in IAS 39 (revised 2000) was made. We consider the latter disclosure requirement as the more important one because it identifies the part of accrued interest income on impaired financial assets (i.e. the portion not already collected in cash) that involves a higher risk of receiving payment. We also note that this particular disclosure (i.e. the paragraph 170(c)(iii) disclosure) had been added by the IASC Board after direct consultation with the Committee. Therefore we recommend adding the disclosure approach followed in paragraph 170(c)(iii) of IAS 39 (revised 2000) into paragraph 21(e) of the draft IFRS.

ED 7.24: Hedge accounting

The draft IFRS does not require disclosure of information about <u>hedge ineffectiveness</u> and its impact on profit and loss. We therefore would recommend a revision of paragraph 24 of ED 7 to require an entity to disclose, separately for fair value hedges and cash flow hedges, the net gain or loss recognised in profit or loss for the period that represents the amount of hedge ineffectiveness. The entity also should describe where the net gain or loss is reported in the income statement.

We believe that this disclosure provides helpful information for users of financial statements, as it can explain some of the volatility in profit and loss. Providing this information in the financial statements should add minimal burden to entities because they are already obliged to measure hedge ineffectiveness according to IAS 39. Furthermore, because this disclosure is already required by US generally accepted accounting principles (GAAP), adding it to the draft IFRS would contribute to the ongoing convergence of IFRS and US GAAP.

ED 7.40(b) and IG23: Analysis of impaired financial assets

Paragraph 40(b) of the draft IFRS requires an analysis of impaired financial assets by class. Under IAS 39, some financial assets are individually assessed for impairment and may be found to be impaired and other financial assets (other than individually impaired assets) are collectively assessed for impairment. Our understanding of paragraph 40(b) and, hence, paragraph IG23, is that this disclosure requirement is intended to apply only to individually impaired assets. However, in our view, the wording of paragraph 40(b) could be read to include groups of collectively assessed financial assets that are determined to have impairment losses. Groups of collectively assessed financial assets would typically include individual financial assets that are past due, but not individually impaired, and which should be disclosed as past due under paragraph 40(a). Therefore, we would recommend that the first part of paragraph 40(b) be revised to read "an analysis of individually assessed financial assets that are impaired as at the reporting date." A corresponding revision should be made to the first sentence of paragraph IG23 so that it reads: "Paragraph 40(b) requires an analysis of individually impaired financial assets by class."

ED 7.41(b): Fair value of collateral

Paragraph 41(b) requires an entity to disclose the fair value of assets obtained during the period by taking control of collateral pledged, less the cost of obtaining the assets. To our mind, disclosing the fair value of these assets "less the cost of selling them" rather than "less the cost of obtaining them" provides more relevant information to users of financial statement. The latter costs have already been incurred and no longer influence the amount expected to be realised from the collateral (in contrast to the costs to sell that will be incurred when the collateral is sold). (Question 10)

ED 7.43 and Appendix B, B10: Market risk and insurance risk

The disclosures concerning market risks in paragraph 43(a) of the draft IFRS (and insurance risk in the amendment to paragraph 39(b) of IFRS 4 that would be made by paragraph B10 of the proposal) require an entity, *inter alia*, to prepare a sensitivity analysis for each type of market risk (and for insurance risk), showing the effects of *reasonably possible* changes in the relevant risk variable on profit or loss and equity. We understand from the proposal's Basis for Conclusions that the Board consciously restrained from prescribing exactly what *"reasonably possible"* means for purposes of the market risk (and insurance risk) disclosures. In this regard, we understand that banks commonly prepare sensitivity analyses for a range of reasonably possible changes in risk variables. Although we are aware of the difficulties lying within an effort to further define the term *"reasonably possible"*, we believe that providing some guidance in this area would be helpful for both preparers and auditors. Moreover, it might contribute to the comparability of the financial statements. Therefore, we recommend that the Board provide some general guidance on the meaning of *"reasonably possible"*, eg, what factors an entity might consider in determining what changes in a risk variable are reasonably possible.

In addition, we believe that an entity's required disclosure of "the methods and assumptions used in preparing the sensitivity analysis" in paragraph 43(b) of the draft IFRS (and in the proposed amendment to paragraph 39(b)(ii) of IFRS 4) should include the specific "reasonably possible" changes that the entity used. We recommend that there be an explicit statement concerning the required disclosure of these "reasonably possible" changes. (Question 3, Question 7)

ED 7.50: Withdrawal of IAS 30

The effective date of ED 7 is 1 January 2007 with earlier adoption encouraged. Unfortunately there are no prescriptions in the draft IFRS on how an entity should deal with IAS 30 in case it adopts the draft IFRS prior to its effective date. Therefore, we would request that the IASB clarify that - as we presume - IAS 30 would no longer be applicable to an entity that adopts ED 7 before 1 January 2007. (Question 5)

ED 7, Appendix B, B10: Amendment of IFRS 4 Insurance contracts

The Committee expects that, in general, insurers would prefer not to implement further changes in their financial reporting shortly after their implementation of IFRS 4. However, we believe that the most appropriate way to modify the disclosures in IFRS 4 is to do so at the same time that IAS 32 is revised because IAS 32 was the main basis for the IFRS 4 disclosures. Overall, we believe that a common disclosure structure should be applied to both banks and insurers with respect to financial instruments. (Question 7)

Comments on ED 7 Basis for Conclusions

ED 7 BC20: Reference to Pillar 3

Paragraph BC20 states that "This guidance is consistent with the disclosure *proposals* for banks developed by the Basel Committee (known as "Pillar 3")". In fact, Pillar 3 contains disclosure *requirements*. Therefore, the wording in this paragraph should be modified. (Question 10)

Comments on ED 7 Implementation Guidance

ED 7 IG7: Qualitative disclosures

Paragraph 34 of the draft IFRS requires qualitative disclosures about risks and risk management. To meet these disclosure requirements, paragraph IG7(c) states that an entity might provide a narrative description of its "policies and procedures for avoiding excessive concentrations of risk and for taking collateral to mitigate risk." However, paragraph IG7(b)(iii) suggests the disclosure of "the entity's policies for hedging or mitigating risk," while paragraph IG7(b)(iv) recommends the disclosure of "the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices." The statement that an entity should disclose its "policies and procedures... for taking collateral to mitigate risk" in paragraph IG7(c) seems to be misplaced because they are a component of the entity's policies for mitigating risk, which would be described under paragraph IG7(b)(iii). We would suggest that paragraph IG7(b)(iii) be revised to read "the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral." A corresponding revision should be made to paragraph IG7(c), which should be shortened to read "the entity's policies and procedures for avoiding concentrations of risk."

In addition, an entity's qualitative disclosures of the risks arising from financial instruments and policies for mitigating these risks could also refer to aspects of its credit risk transfer (CRT) activities. These activities have been developing at a rapid rate and are characterised by significant product innovation, an increasing number of market participants and growth in overall transaction volumes. As we believe such information falls within the intended scope of overall risk disclosure principles and would provide an important insight into this growing risk management activity, we recommend that paragraph IG7 be amended to require a description of the nature of its CRT activities, including the purpose and nature of CRT transactions employed. Paragraph IG7 might also be further amended to require an entity to consider disclosing the effect of CRT transactions on the summary information and breakdowns (eg, by credit quality, industry or geography) of credit exposures it provides for financial assets."

ED 7 IG9 and IG19: Disclosures of loans

Credit risk is one of the most important risk factors for banks. Therefore, from a supervisory perspective, we see high quality risk management practices for the loan portfolios of banks as an essential element of sound banking practices. Markets should have the opportunity to evaluate a bank's risk management practices as well as its exposure to credit risk and link these factors to the economic performance of the bank. Pillar 3 of the Basel II framework provides an adequate level of disclosure in this context for banks. Considering the illustrations in the Implementation Guidance, we believe that the draft IFRS, which will apply to all entities and not just to banks, generally provides appropriate credit risk disclosure requirements that are in line with those in Pillar 3. (Question 8)

ED 7 IG14: Maximum credit risk exposure

Paragraph IG14 describes activities that give rise to credit risk and the associated maximum exposure to credit risk from these activities. Paragraph IG14(d) refers to "making a loan commitment that is irrevocable over the life of the facility." A loan commitment may also be revocable only in the event of a "material adverse change." Provided such a change has not occurred, an entity that has granted such a loan commitment would be obligated to advance funds upon the request of the counterparty to the commitment, which means that the entity granting the commitment is exposed to credit risk. As written, paragraph IG14(d) may be misinterpreted to mean that only irrevocable loan commitments give risk to credit risk. In addition, paragraph IG14(d) states that "the maximum credit exposure is the full amount of the commitment, because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future." If a loan commitment has been partially drawn upon (and to that extent already shown in granted loans under paragraph IG14(a)), the maximum credit exposure from the commitment is the portion available to be drawn, not the full amount of the commitment. Therefore, we suggest that paragraph IG14(d) be revised to read "making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the loan commitment cannot be settled net in cash or another financial instrument, the maximum credit exposure is the amount available to be drawn under the commitment, because it is uncertain whether this available amount may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability."

ED 7 IG20: Financial assets that are past due

Paragraph IG20 on past due financial assets provides an example where "an entity enters into a lending agreement that requires interest to be paid every thirty days." All months do not have thirty days. It is more common for a lending agreement to require monthly interest payments that must be paid on the same day of each month, e.g., the first day of the month. In addition, we consider a loan to be past due if the interest has not been paid by the close of business on the day the payment is due. Therefore, we would suggest that the example in paragraph IG20 be revised to read: "As an example, an entity enters into a lending agreement that requires interest to be paid on the first day of each month. If interest has not been paid by the close of business on the first day of the month, the loan is past due."

ED 7 IG25: Contractual maturity analysis

In paragraph IG25, the draft IFRS addresses how an entity should include financial liabilities for which the entity or a counterparty has a choice over when to pay an amount in the contractual maturity analysis for the liquidity risk disclosures. As an example of financial liabilities that provide this choice, the paragraph identifies financial liabilities that are repayable on demand such as demand deposits. In contrast, time deposits have a contractual maturity, but the depositor may in some cases choose to redeem the deposit prior to maturity (and may be subject to a penalty for doing so). Thus, time deposit liabilities might be viewed as giving the counterparty (the depositor) a choice over when to withdraw an amount. However, we believe it would be misleading for a bank to include all of its time deposits in the earliest time band in the contractual maturity analysis. We therefore recommend that the IASB clarify that time deposit liabilities should be reported based on their contractual maturity and should not be treated as liabilities for which the counterparty has a choice over when the deposit should be paid.

ED 7 IG29-30: Liquidity management

According to the Committee’s paper *Sound Practices for Managing Liquidity in Banking Organisations* (February 2000), "public disclosure is an important element of liquidity management. Experience has shown that when there is a more continuous stream of information about a bank, it is easier to manage market perceptions during times of stress. Banks should be certain to provide an adequate amount of information on an ongoing basis to the public at large and, in particular, to major creditors and counterparties."

Considering that ED 7 is principles-based and applicable to all entities and that there is no one single approach that banks follow to manage their liquidity risk, we consider the disclosure requirements in ED 7 that pertain to this risk to be reasonable. Moreover, we agree that, consistent with paragraph IG30, it is important for a bank to provide as an additional disclosure a maturity analysis based on expected maturity dates of both financial liabilities and financial assets rather than disclosing only a contractual maturity analysis of financial liabilities. (Question 8)

Paragraph IG29 identifies factors that an entity may consider in providing a description of how it manages the liquidity risk inherent in the maturity analysis of financial liabilities that is required by paragraph 42(a). The financial liabilities that are required to be disclosed by paragraph 42(a) include undrawn loan commitments, but it is common for an entity to expect, based on its experience, that a portion of these commitments (and, in some cases, a substantial portion) will not be drawn upon. We would suggest that a new subparagraph (b) be added to paragraph IG29 to cover this situation. This new subparagraph (b) would specify that a factor that an entity may consider is whether the entity "expects some of its undrawn loan commitments not to be drawn upon."

Paragraph 42(a) of the draft IFRS on financial liability contractual maturity disclosures is supported by paragraph IG30, which permits the additional disclosure of an expected maturity analysis. This provides an option for banks that undertake asset/liability management (ALM) in this manner. For insurers, however, the draft IFRS recognises that contractual maturity is not a meaningful concept because the "maturity date" of insurance liabilities depends on when the insured event occurs. Helpful implementation guidance for insurers has been provided in paragraph IG62A of IFRS 4, a new paragraph that paragraph B11 of the draft IFRS would add to IFRS 4, but we could not determine whether the liquidity disclosures described in this new paragraph replace or supplement the contractual maturity disclosures required by paragraph 42(a) of the draft IFRS. We recommend that this be clarified for insurers.

We also note that the proposed new paragraph IG62A of IFRS 4 refers to paragraph 50(a) of the draft IFRS. This latter paragraph reference is incorrect and should be changed to paragraph 42(a).

Annex

This Annex presents the Committee's recommended revision of the second Illustrative Example in paragraph IE2 of the Implementation Guidance in the draft IFRS.

Illustrative example for an entity that is not in compliance with externally imposed industry-wide capital requirements

IE2 The following example illustrates the application of the disclosure requirement in paragraphs 47(d) and (e) when an entity is not in compliance with externally imposed industry-wide minimum capital requirements at the reporting date. Other disclosures would be provided to comply with the other requirements of paragraph 47.

Facts

Entity A provides financial services to its customers and is subject to industry-wide minimum capital requirements imposed by its prudential supervisor. At the reporting date, 31 December 2007, Entity A was not in compliance with these industry-wide minimum capital requirements. In its financial statements for the year ended 31 December 2007, Entity A provides the following disclosure relating to its non-compliance.

Disclosure

At 31 December 2007, the amount of Entity A's regulatory capital was below the industry-wide minimum capital requirement imposed by its prudential supervisor by CU1 million. As a result, Entity A was required to submit a plan to the supervisor describing the actions it would take to comply with the minimum capital requirement by increasing the amount of its regulatory capital and/or reducing the amount of its asset base. Entity A submitted a plan that entailed selling specified investments from its fixed-rate investment portfolio with a carrying amount of CU11.5 million in the first quarter of 2008. Entity A sold these investments in February 2008 for CU12.6 million, which brought it into compliance with the industry-wide minimum capital requirement.