

# ISDA

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## **ED-7 Disclosures for financial instruments**

Dear Ms Pryde,

ISDA appreciates the opportunity to comment on Exposure Draft 7 (“ED”) on Financial Instruments: Disclosures published by the International Accounting Standards Board (“IASB” or “the Board”) in July 2004.

Our members represent leading participants in the privately negotiated derivatives industry and include most of the world’s major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the IASB’s work on accounting for financial instruments.

### **Key messages**

ISDA is supportive of the IASB’s objective to develop a single standard covering the disclosure of financial instruments in an entity’s financial statements. However, we are concerned that whilst there is a clear move in ED 7 towards making the requirements principles-based, the disclosures are still prescriptive and are not sufficiently based on a clearly established set of principles. As is set out in more detail in this letter, we believe that the level and type of disclosure will often depend on the context. By rephrasing the standard in terms of a series of disclosure principles, it should then be left to reporting entities to determine what disclosure is necessary in order to communicate the entities’ risks adequately to the readers of financial statements. Much of the detail contained in the main body of the standard should therefore be moved to the application guidance, as examples of possible disclosures.

We also highlight the following specific concerns that will need to be addressed prior to finalising the standard:

- ISDA does not believe it is appropriate to require subsidiary companies, unless they have listed instruments in issue, to provide the detailed risk disclosures proposed (e.g. sensitivity analysis and capital

disclosures), where this information is provided in the consolidated financial statements of their parent. An entity would still have the option to voluntarily adopt these disclosures should they consider them useful to their user group.

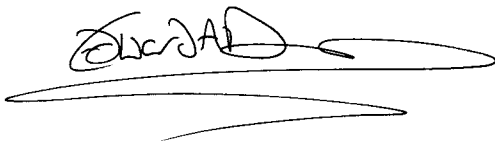
- We do not support the proposals to include all risk disclosures arising from financial instruments in the audited financial statements. Whilst risk disclosures provide valuable information to a user on the entity's use of capital and exposure to risks, they do not provide additional detail and understanding of the financial performance reported in the balance sheet and profit or loss account. We therefore consider these disclosures should be provided for outside the audited sections of the annual report.
- We believe that the proposed credit risk disclosures are not principles based and may lead to inaccurate presentation of an entity's credit exposures. In particular, the proposals do not permit the reporting of credit exposures after taking into account legally enforceable master netting agreements even though these provide an unconditional right and ability to settle net in the event of default.
- We share the Board's view that it is appropriate to disclose information that enables shareholders and analysts to evaluate the nature and use of an entity's capital but do not support the proposals to disclose whether it has complied with internal capital targets set by management. Internal targets are deployed in conjunction with other control measures and a breach of these limits is often acceptable with appropriate approval. We therefore do not consider this to be useful or relevant information for a user to assess the financial position and recent performance of the company.

The appendix to this letter sets out our detailed answers to the questions posed by the Board. We would be pleased to discuss our comments with the Board or staff. Please contact Melissa Allen at CSFB on (020) 7883 3598 or Ed Duncan at ISDA on (020) 7330 3574.

Yours sincerely



Melissa Allen  
Chair of the ISDA European Accounting Committee.



Ed Duncan  
Assistant Director of European Policy at ISDA.

## Appendix

*Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance*

*The draft IFRS incorporates disclosures at present contained in IAS 32 Financial Instruments: Disclosure and Presentation so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:*

- (a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).*
- (b) information about any allowance account (see paragraphs 17 and BC14).*
- (c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).*
- (d) fee income and expense (see paragraphs 21(d) and BC17).*

*Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?*

ISDA agrees that the proposed additional disclosures could provide relevant information to users of financial statements. However, we consider the requirements should be less prescriptive and more principles based so as to allow preparers to provide disclosure in a format appropriate for the complexity of the business and that is consistent with the way the business is managed. For example, the proposals currently require an entity to disclose the net gains or losses by classification of the financial instruments when often it would be more appropriate to disclose this information by business line or function. Providing more flexibility is essential as there are many different users of financial statements and it is important the disclosures provide information that will help them evaluate the significance of financial instruments on the entity's performance.

Underlying our desire for ED7 to be revised to a series of disclosure principles is the recognition that the markets encourage and promote adequate disclosure. Many US organisations already disclose more financial information than is required by US GAAP, in order to seek to communicate adequately their risks to the readers of the financial statements. The level of disclosure should therefore, in part, reflect the demands of the users of financial statements which will vary significantly from one business to another, from one country to another, and will also depend upon whether the entity is listed or private, or part of a larger group.

ISDA is also concerned that many practical application issues will arise if entities are required to apply prescriptive minimum disclosures. For example, paragraphs 21 (a) (iv) and (v) require disclosure of the net gains and losses on loans and receivables and financial liabilities held at amortised cost. However, where these financial instruments are part of a fair value hedge relationship it is not clear whether the disclosure should include movements in the fair value attributable to the hedged risk.

Another example of the potential practical implementation issues is the disclosure required by paragraph 21 (d) regarding fee income and expense. Structured derivative trades often embed underwriting and origination fees in the overall pricing of the derivative. We are concerned that it could be interpreted that these fees should be separated and disclosed as fee income rather than net gains and losses on financial instruments at fair value through profit or loss. Separating income on derivatives for disclosure purposes would not provide valuable information to a user and would, in practice, be very difficult to produce as an entity does not analyse the fair value of derivatives on this basis.

If the Board continues with their proposal to require prescriptive minimum disclosures in the financial statements then they must provide further explanation of the purpose of the disclosures. Entities will then be able to interpret the requirements and provide what they consider to be the most appropriate and relevant disclosures.

*Question 2 – Disclosure of the fair value of collateral and other credit enhancements*

*For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).*

*Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?*

ISDA believes that an entity with financial assets should provide adequate disclosure on its exposure to credit risk and on the management of collateral. However, we consider that whilst all entities should be required to disclose their credit policy and the methods used to manage credit risk, the level of detailed disclosure should vary depending on the significance of their exposure to credit risk. As currently worded, we are concerned the proposed disclosure of the fair value of collateral and other credit enhancements lack context and may be better embedded in an over-arching disclosure principle. In particular:

- a) the information required in respect of the fair value of collateral and other credit enhancements is more detailed and prescriptive than required by the proposals for other risk information; and
- b) the information will be of limited value to the reader of financial statements without a wider understanding of the nature of the entity's credit activities and how the collateral is used.

When reviewing these disclosures, a user may draw the inference that collateralised loans are lower risk than uncollateralised loans, which will not necessarily be the case as it will depend on the nature of the lending activity and the credit worthiness of borrowers. Also, the fair value of collateral will be a meaningless figure, without comparison against the specific loans that it is designed to collateralise; an entity could have certain loans that are over-collateralised and other loans where insufficient collateral is held, and the disclosures required by ED 7 would not provide a reader with this understanding.

In addition, the proposals do not permit an entity to disclose their credit exposure after legally enforceable master netting agreements have been taken into account, even though these will provide an unconditional right and ability to settle net in the event of default. If the disclosures are to accurately reflect the credit risk of an entity, they should disclose the loss that the entity will suffer if a counterparty fails to meet its contractual obligations. Therefore the disclosure must be provided after applying any master netting agreements.

We would therefore prefer to see the disclosure requirements in respect of the fair value of collateral and credit enhancements focus more on providing sufficient information about the management of credit risk and methods of credit enhancement. This would enable the reader to obtain an understanding of the risks of the business. Much of the other proposed disclosures concerning collateral should be included in the application guidance, as a possible way of achieving this disclosure.

Finally, the Board should reconsider paragraph 39 (a) which requires disclosure by classification of financial instrument "the amount that best represents its maximum exposure to credit risk at the reporting date...". We are concerned that this disclosure could be misinterpreted since "maximum exposure" for a derivative is normally considered to be the potential maximum future exposure, which will usually be considerably greater than the fair value of the instrument suggested in the guidance. We therefore ask the IASB for further clarity on this issue.

*Question 3 – Disclosure of a sensitivity analysis*

*For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36 - BC39).*

*Is the proposed disclosure of a sensitivity analysis practicable for all entities?*

*If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?*

ISDA agrees with the principle that an entity should disclose sensitivity analysis in the annual reports showing the effect of reasonable changes in market risk variables on the fair value of financial instruments. However, consistent with our responses to the questions above, we consider the requirements should be less prescriptive and more principles based to allow preparers to provide disclosure consistent with the information used to manage the business risks.

In particular, we do not believe that it is appropriate to require sensitivity analysis for entities that are subsidiaries and whose results are reflected in consolidated financial statements of a parent which provides the risk disclosures, unless that entity has itself listed securities or chooses to make the disclosure because of specific user requirements. In these situations the information will not normally be useful to stakeholders. For example, many lenders to subsidiaries make credit decisions, in large part, on the basis of guarantees provided by the parent and therefore detailed information on the subsidiary may be of limited value to this user group.

It is also important to note that many entities manage risk on a business unit or group wide basis. As such, the risk systems for these entities are designed to capture risk information at that level rather than at an entity level. Although this would mean the information is available, significant time and effort would be required to cut the information and provide it on a subsidiary-by-subsidary basis. For completeness, the group would then need to capture intra-group risks that would often not be captured on the risk reporting system to the same level of detail. Furthermore, as risk management practices may span across portfolios which include assets and liabilities recorded under different accounting models, it would be difficult if not impossible to designate the potential impact on profit or loss versus equity, as required by the ED.

In measuring their sensitivity to market risk many banks will use a statistical Value at Risk (“VaR”) methodology that expresses potential loss on a portfolio at a specified confidence level eg, 95% confidence. It is not clear in the proposals whether VaR is an acceptable way of meeting the sensitivity analysis requirements under all circumstances and we would like to see the Implementation Guidance amended to clarify the situations in which a VaR analysis is considered acceptable.

Finally, should the Board continue with the checklist of minimum disclosures, we are concerned the current proposals do not provide clarity on the amount of information that will normally be required. For instance, is it sufficient to provide the foreign exchange exposure analysis in aggregate or by currency? Consistent with our views expressed elsewhere in this letter, illustrative examples should be provided in the implementation guidance to help demonstrate the appropriate level of disclosure.

*Question 4 – Capital disclosures*

*The draft IFRS proposes disclosure of information that enables users of an entity’s financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity’s objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the*

*period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45 - BC54).*

*Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?*

Given that much of the capital base of most entities is made up of retained earnings, which is not a financial instrument, and most of the risks faced by non-financial entities that prompt the need for capital are unrelated to financial instruments, it is not clear why capital disclosures are proposed in an ED on the disclosure of financial instruments.

Nevertheless, good management of capital is an integral part of providing consistent and high quality returns to shareholders. We therefore share the IASB's view that it is appropriate to disclose, where practical, information that enables shareholders and analysts to evaluate the nature and use of a company's capital. However, in our view there needs to be more flexibility provided so that an entity can determine appropriate capital disclosures. In particular, outside of financial institutions, there is no established framework for determining capital requirements. This is illustrated by the example given in the draft Implementation Guidance, IE1, where a debt to equity ratio is disclosed without an apparent logical justification. Quantitative measures of the required level of capital are not currently used by many entities for management purposes, would be onerous to produce, and would vary so significantly from one entity to another that comparison may not be possible. We consider it important, first, to establish a generally accepted basis of calculation and for this to be adequately field tested before disclosure is required to be given by all entities.

We also recommend that, except in the case of regulated entities, capital information disclosures should only be required at the group level (see our comments relating to sensitivity analyses above).

ISDA agrees that it is appropriate for financial institutions to disclose key capital figures and ratios compared to the minimum regulatory requirements at the period end, although we do not support the proposal to disclose internal capital targets and regulatory breaches arising in the period. Different organisations view internal targets in very different ways, some being set with the expectation that they will never be exceeded and others using them as a more active control framework, in much the same way as risk position limits, where capital excesses can be tolerated in limited circumstances, with appropriate approvals. Also, internal capital targets are often deployed in conjunction with other control measures, and so the proposed disclosure may at best only provide a small part of the picture.

Breaches of capital limits would in many cases be confidential information and we believe it should be the regulator that decides whether a breach is communicated to the public. For example, disclosure of a breach that occurred during the course of the year, which has since been corrected, would be of limited value and potentially misleading, especially if the breach was for minor or technical reasons.

#### *Question 5 – Effective date and transition*

*The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62 - BC67).*

*Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).*

*Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?*

The proposed effective date is appropriate, on the basis that certain of the proposals are not included in the final version of the Standard, as recommended in this response. In particular, we are concerned that non-financial institutions may not have the capability to produce the new detailed sensitivity analyses on their Available For Sale or Held To Maturity assets by 1 January 2007 and believe that it would be premature to require quantitative information concerning capital (see question 4) by this date. In addition, we do not see significant benefits from providing this information for subsidiary companies in this timescale, if at all.

With Europe and many other countries adopting IFRS in 2005, many companies will be preparing their first set of IFRS accounts towards the end of next year. Rather than preparing the disclosures under IAS 32 they may prefer to adopt the standard early. We would therefore encourage the Board to finalise these proposals as soon as practicable.

*Question 6 – Location of disclosures of risks arising from financial instruments*

*The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.*

*Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?*

No, we do not believe that the financial statements are the best place for many of the disclosures proposed in the draft standard. While ISDA believes that disclosures which analyse the results reported in the balance sheet and profit or loss account should be included in the notes to the financial statements, ED 7 proposes comprehensive disclosure of an entity's risk positions (in particular, the sensitivity analysis and capital disclosures) and further disclosures that provide information on how a business manages its risk. Although these risk disclosures provide valuable information to a user of the impact in the movement of market variables, such as interest rate risk, on the business, they do not directly relate to the audited financial results reported in the balance sheet and profit or loss account.

We are also concerned that the costs involved in having this information audited would not be commensurate with the value of the information to readers. Therefore, although ISDA agrees that these disclosures should be included in a company's annual report we believe that they should not form part of the audited financial statements.

*Question 7 – Consequential amendments to IFRS 4  
(paragraph B10 of Appendix B)*

*Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57 - BC61.*

*Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?*

The majority of ISDA’s members will not be affected by the proposals to amend the risk disclosures in IFRS 4 to be consistent with the requirements proposed in the ED 7. We therefore have not provided a response to this question.

*Question 8 – Implementation Guidance*

*The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42 - BC44).*

*Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?*

ISDA believes the Implementation Guidance should include additional comprehensive practical examples of applying the standard to both financial and non-financial companies. In particular, it would be helpful if examples were provided showing the level of disclosure expected of companies that make extensive use of financial instruments and those that use them for financing and for investment. In addition, there are a number of proposals where no guidance is currently provided at all, such as for paragraphs 31(a) and 40(b). We recommend the final standard include implementation guidance for all the proposed disclosure to encourage consistent application. In providing further illustration it should, however, be made clear, the level of disclosure will depend on the particular circumstances of each entity, and that this will mean the disclosures given by different entities may not be easily comparable.

*Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards Fair Value Measurements published by the US Financial Accounting Standards Board (FASB).*

*The FASB’s Proposed Statement of Financial Accounting Standards Fair Value Measurements, which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:*

*(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)*

*(i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,*

*(ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and*

*(iii) the effect of the remeasurements on earnings for the period (unrealised gains or losses) relating to those assets and liabilities still held at the reporting date.*

*(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of*

*(i) the reason for remeasurements,*

- (ii) *the fair value amounts,*
- (iii) *how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and*
- (iv) *the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.*

*Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).*

*Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?*

ISDA agrees that the disclosure requirements of ED 7 would provide adequate disclosure of fair value changes compared with those proposed in the Financial Accounting Standards Board's Exposure Draft. We are supportive of the principles behind the disclosures required by the FASB's Exposure Draft, however we did recommend in our comment letter, a copy of which is attached, that the proposed disclosure of the amount of unrealized gains or losses associated with fair value measurements be removed, as this does not provide useful information and could be misleading to financial statement users.

It is important to note that disclosures required by this FASB Exposure Draft would be supplemented by the qualitative disclosures that are already made regarding fair value measurements. Currently, much of this qualitative information regarding valuation and valuation techniques is disclosed within many banks' and broker-dealers' critical accounting estimate disclosures in the Management's Discussion & Analysis section of their public filings, which sit outside the audited financial statements.

*Question 10 – Other comments*

*Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?*

In addition to our comments to questions one to nine, we have detailed below several concerns with the detailed proposals that should be addressed prior to finalising the standard. The Board should consider these matters in the context of our comments above and ensure it is clear from the implementation guidance in the final standard the type and extent of the suggested disclosures.

***Paragraph 11 – Financial liability at fair value through profit or loss***

An example where the ED is overly prescriptive as opposed to principles-based, is that paragraph 11 states a disclosure requirement, without explaining why it is required. We assume that the objective of paragraph 11 is for the reader of the financial statements to understand the extent to which profits or losses booked in any year arise from changes in the entity's own credit risk. If this is the case, then the Standard will need to state this. As worded, the information provided will not be sufficient to enable a reader to understand the effect of changes in own credit risk, since there could be other factors involved in an instrument's change in fair value unrelated to the benchmark interest rate, such as the effect of an embedded derivative.

Also, while we agree that the information required by paragraph 11(b) is necessary, it is not clear how entities are expected to determine the amount contractually required to be paid at maturity. In cases where a bond is

issued with the principle linked to, say, equity prices, all that would be capable of being disclosed would be the amount that would be required to be paid if equity prices do not change, plus any further information to ensure the reader understands that the number could, and will, be different at maturity.

***Paragraph 19 – Defaults and breaches***

As with our comments on capital, above, we are concerned that the information will not always be in the public domain and the information may not be useful.

***Paragraph 23(b) – Accounting policies***

It is not clear why there should be criteria for designating financial assets as Available For Sale, since this will normally be the default category. The only discretion is if a firm (for instance) decides that loans should be classified as AFS, in which case the suggested disclosure should be amended to make this clear.

***Paragraph 23(f) – Accounting policies***

We consider this paragraph requires rewording. By definition, an item is “past due” until it is paid. Therefore whether an item is still past due or not is a matter of fact, rather than an issue of policy. We presume that it is intended that disclosure should be made of the policy for determining if loans are no longer impaired and when provisions can be released.

***Paragraph 24 – Hedge accounting***

The hedge accounting disclosure should also include disclosure of the change in the value of the items being hedged. This will then provide the user with an overview of the entity’s hedge accounting transaction.

***Paragraphs 31(b) and (c) – Fair value***

As worded, this could be answered “yes” or “no”. The requirement should presumably not be “whether”, but “the extent to which”, making it clear that a quantitative response is expected.

We would also encourage the Board to revise the fair value disclosure required under paragraph 31 (c). We are concerned the proposals, in requiring reasonable alternative fair values to be disclosed, would be inconsistent with the fair value hierarchy prescribed in IAS 39. We would be pleased to assist the Board in developing alternative guidance.

***Paragraph 40(b) – Financial assets past due or impaired***

As currently worded it is not clear as to what level of detail is expected in relation to this paragraph. For a non-financial institution this might only require a few lines but the information, for a bank, could run to many pages. As with a number of the other requirements in ED 7, an entity should disclose sufficient information to enable readers of the financial statements to understand adequately the risks of the entity.

***Paragraph 41 – Collateral and other credit enhancements obtained***

For a bank, the information required by paragraph 41 would be far too detailed unless provided only in aggregate. Further clarification should be provided in the final standard as to the objective of this disclosure.