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Principles for disclosures in times of stress (Lessons learnt from the financial crisis)

Introduction

The 2008-2009 financial market crisis has underlined the fact that high quality disclosures are a critical component in maintaining market confidence. Providing adequate information has proved to be an important means for financial institutions to show market participants how they have been affected by the crisis and enables users to make their own assessment.

Based on the findings of CEBS's work assessing banks' disclosures in the wake of the publication of its list of good practices in June 2008 '[Report on banks' transparency on activities and products affected by the recent market turmoil](#)' CEBS decided to develop a set of disclosure principles that reflect the lessons learnt from the financial crisis and assist institutions in improving the quality of their public disclosure.¹

The present principles have been reviewed and revised in the light of the comments received in response to the Consultation Paper (CP) 30 *Draft disclosure guidelines: Lessons learnt from the financial crisis*.

Objective

The disclosure principles are intended to guide financial institutions in the preparation, in times of stress, of public disclosures made to conform with existing disclosure requirements and recommendations, or on an ad hoc basis.

The objective of the principles is to contribute to further improvements in the quality of disclosures, in terms of substance, presentation and internal consistency. They do not aim to increase the quantity of information provided.

Although many of the principles in the document are valid in normal circumstances, the principles are built on observations made in the context of situations of stress, especially during the subprime crisis and later on during the wider financial crisis and, therefore, are primarily intended to assist institutions in preparing disclosures related to stressed circumstances.

For the purposes of this work, a situation of stress is deemed to be one where an event, activity or risk – irrespective of whether it has its origin in a single entity, in one particular event, or in market or economic developments - has or could have a material effect on a financial institution's financial position (including, for example, the level of capital, the solvency ratio and the liquidity position).

¹ CEBS carried out a number of assessments which allowed the identification of good practices and weaknesses. In the assessments CEBS took into consideration the recommendations of the Senior Supervisors Group and put forward in the Financial Stability Forum's April 2008 Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (http://www.financialstabilityboard.org/publications/r_0804.pdf) but also looked at more qualitative issues such as disclosures on business models, risk management and accounting policies.

The principles do not set any additional requirements for items or information to be disclosed. Rather they aim to encourage enhanced quality of disclosures without amending, duplicating or adding to existing disclosure requirements or recommendations - such as IFRS, Pillar 3, listing rules or other regulations - institutions may be subject to.

This document is divided into three parts. The first part deals with the general principles that CEBS deems necessary to achieve high quality disclosures. The second part outlines the content of disclosures on areas or activities under stress. The third and last part provides guidance on presentational aspects.

I. GENERAL PRINCIPLES

1. Financial institutions should provide timely and up to date information

This principle encourages financial institutions to disclose relevant information in a timely manner. Undue delay in the disclosure of information may affect its relevance. The sub-prime crisis emphasised the detrimental effects of communications which were not always sufficiently timely, particularly in the early stages of the crisis. Financial institutions should, therefore, be alert to the need to provide timely information.

This could justify the provision of extra communication documents or updates outside the normal publication calendar whenever there is a material change to existing disclosures. These could contain targeted information explaining the effects of a particular situation. However, such documents are not intended to replace regular reports that an institution provides in accordance with applicable regulations.

2. Financial institutions should provide disclosures on areas of uncertainty

The objective of this principle is to ensure that financial institutions shed sufficient light on areas of uncertainty and their possible development and evolution. Disclosures must faithfully represent the underlying transactions and events; therefore, it is important that institutions provide clear information on key estimates or management judgements that are used in areas of uncertainty (e.g. valuation of financial instruments in the absence of quoted market prices).

CEBS encourages institutions to make use of sensitivity analyses and to discuss the related assumptions and probabilities of occurrence to enable users to form an opinion on the potential impact of changes in expectations.

3. Financial institutions should provide comprehensive and meaningful information that fully describes their financial situation

To enable market participants to make a meaningful assessment of an institution's financial situation, information should be comprehensive. When assessing the information that is necessary to achieve this objective, management should aim to provide decision-useful information, bearing in mind that omissions of information can be misleading.

Given the heterogeneity of users of institutions' financial reporting, some concise background information on the wider economic environment that an institution operates in may be necessary to understand the context for specific disclosures.

Financial institutions should also actively consider whether current or past disclosures should be 'rolled forward' without change or should be adapted as a situation evolves.

CEBS realises that, in stressed situations, certain information may be sensitive and could even have a destabilising effect on an institution's position. Where a situation is deemed to be of particular concern, it is expected that competent regulatory or supervisory authorities are aware and informed and, if necessary, involved in discussing possible measures to address the situation with due regard given to an institution's ongoing disclosure obligations.

4. Disclosures should allow comparisons over time and between institutions

This principle aims at enhancing comparability of disclosures, both over time and between institutions.

Comparability over time is essential to allow users to monitor the evolution of an entity and is especially important in prolonged periods of turbulence. This was clearly illustrated by the disclosure recommendations developed by the Financial Stability Forum and the Senior Supervisors Group.²

In addition, financial institutions should present their disclosures in a way that facilitates comparability across institutions. Discussions in industry fora, analysis of peer disclosures and, for specific information items (in particular for quantitative disclosures) standardised formats are considered very useful in this regard. Past (and ongoing) industry initiatives, e.g. on securitisation disclosures are positive examples of such efforts.³

5. Financial institutions should seek to early adopt new disclosure regulations

This principle aims to encourage financial institutions to early adopt new disclosure standards and best practice recommendations – whether issued by standard-setters, supervisors or regulators - as soon as possible, especially if these have been issued to deal with activities that are under stress. In that respect, financial institutions should disclose whether new disclosure regulations have been adopted and the reasons behind their decision.

² This again refers to the tables prepared by the Senior Supervisors Group and put forward in the Financial Stability Forum's April 2008 Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience. http://www.financialstabilityboard.org/publications/r_0804.pdf.

³ This refers, among other issues, to the work carried out by a number of industry associations (the European Banking Federation, London Investment Banking Association, European Savings Banks Association, European Association of Public Banks and Funding Agencies) which resulted in their Industry Good Practice Guidelines on Pillar 3 Disclosure Requirements for Securitisation. <http://www.liba.org.uk/issues/2008/Dec%2008/D2499A-Good%20practice%20guidelines%20on%20P3-4%20Dec%202008.pdf>

6. Financial institutions should specify whether and to what extent information has been reviewed or verified by external auditors

Financial institutions should specify clearly what information is audited and what is not and, where relevant, whether it has been subject to a different level of assurance.

Similarly, financial institutions should ensure that the information has been through adequate internal verification processes for public disclosure.

II. CONTENT

7. Financial institutions should provide sufficient information on the business model underlying the activities under stress and their significance

Disclosures should cover:

- background information on the business model underlying the activities under stress (to put the disclosures into context) with a description of the degree of involvement of an institution in such activities;
- an explanation of how activities contribute to an institution's value creation process;
- a discussion of the impact a stressed situation has had on the institution's strategy and objectives, including changes in business orientation or policies.

To understand an institution's overall risk profile, it is important to know why and to what extent the institution is engaged in activities that may have material adverse effects on its financial situation. The precise nature of the activities where difficulties have been encountered (or where they are likely to arise in the short-term) should be stated clearly. The information should be concise and focused.

In particular, it is important that institutions explain the significance of activities for their business. Where the institution intends to adapt its business model or discontinue certain activities, this should be clearly explained so users can understand the extent and rationale of the change.

8. Financial institutions should provide clear and accurate information regarding the impacts the activities under stress have on results and on risk exposures

Disclosures should cover:

- the level of exposures related to the activities under stress and the precise nature of the risks involved ;
- detailed information on losses;
- the nature of the protection implemented or acquired to cover the risk and the quantitative impact of risk mitigation;
- some narrative comments on possible developments in the situation.

To allow readers to form a fair opinion of the risks incurred and the level of exposure, institutions are encouraged to present the information at an appropriate level of granularity (providing breakdowns by, for example, type of activities or instruments, geographical areas, business segments or credit quality, where relevant).

In the current crisis, it has appeared most useful for institutions to describe their exposures both before and after hedging, as well as for major instruments to provide notional and carrying amounts. This has provided a useful means of evaluating the impact of possible developments in the situation. A distinction between realised and unrealised losses is also encouraged, as it provides extremely valuable information to users, especially in a fair value environment. Indeed, while realised losses relate to transactions that have been completed, unrealised losses relate to on-going activities and may, therefore, be reversed.

A clear and detailed description of the impact of the activities under stress on the income statement is desirable to support a user's overall understanding of the institution's results.

Banks are also encouraged to provide – with the necessary care - information on their expectations regarding possible developments in the situation.

9. Financial institutions should provide information regarding impacts on the institution's financial position

Disclosures should cover:

- the impact of the activities in question on the level of capital and on the resulting solvency ratio; and
- the impact on the institution's liquidity position.

The protection offered by the level and quality of the institution's capital contributes significantly to market confidence.

The solvency ratio provides a kind of synthesis of an institution's financial situation since it reflects the changes in own funds and also any possible reassessment of risks in a deteriorating situation. Detailed disclosures are, therefore, needed to explain changes in the level of the solvency ratio due to the stressed situation and, in the extreme circumstances observed during the financial crisis, any recapitalisation measures taken to face it.

Also, institutions are expected to provide some detail of the impact on the institution's liquidity position. If quantitative data on liquidity is considered sensitive or detrimental to an institution's situation, there should be, at least, sufficient qualitative disclosures to give users an understanding of its position.

10. Financial institutions should provide information on the management of the risks involved in activities under stress

Disclosures should cover:

- a description of relevant risk management practices, including associated governance arrangements where necessary; and
- a description of any measures taken to enhance risk management processes.

Institutions are urged to avoid generic information on their processes for identifying, measuring, controlling and monitoring risks.

Institutions should include specific information on the risk management of the activities or instruments concerned, such as specific valuation and reporting processes, effective operational limits and corrective measures underway to enhance those processes where necessary (including those decided after the reporting date).

11. Financial institutions should provide detailed information with regard to critical accounting issues

Disclosures should cover:

- an adequate description of the accounting policies that are of particular relevance for the activities in question;
- details of relevant changes, if any; and
- detailed information where significant judgement has been applied.

Financial institutions are encouraged to highlight accounting policies that are of particular relevance for the areas or activities under stress. Such descriptions are most valuable when they focus on the specificities of the situation faced by the institution, rather than recycling generic descriptions.

Clear information on management's judgements affecting accounting figures is of the utmost importance as it can significantly affect the amounts recognised in the financial statements. Particular focus should be given to areas where management judgement is applied to areas or activities under stress. This includes, in the context of the recent financial crisis for instance, fair values for financial instruments (especially when marked-to-model), impairment of financial and intangible assets and defined benefit pension schemes (although care should be taken not to automatically roll-forward such disclosures).

III. PRESENTATIONAL ISSUES

12. Financial institutions should ensure that disclosures regarding activities under stress can be easily located

CEBS has experienced that disclosures on specific events or situations under stress are particularly helpful when provided together in one section of a report / document or in a specific communiqué. Irrespective of the presentation, it is essential that, where appropriate, the disclosures are accompanied by appropriate cross-references to allow users to navigate between all relevant information.

Financial institutions should generally ensure that different disclosures can be easily accessed and located by all potential users. An institutions' website in most cases appears to be the best location to post disclosures (or indications where to find them).

13. Financial institutions should provide information at an appropriate level of granularity

The appropriate level of granularity for disclosure purposes is based on management's assessment. In considering the appropriate level of granularity, financial institutions should strive to disaggregate information on items that do not share similar characteristics. The information should be presented in a clear and transparent fashion, without resulting in information overload.

14. Financial institutions should strike an appropriate balance between quantitative information and narrative information

Generic (or "boilerplate") disclosures which simply add to the quantity rather than quality of disclosure and fail to convey meaningful information should be avoided.

The use of tabular formats for quantitative information may be useful in providing clarity and increasing comparability across institutions. Associated narrative information should add value to quantitative disclosures by way of analysis and interpretation. The use of illustrative tables and overviews is encouraged as it is deemed particularly helpful in guiding the readers through the report.

15. Financial institutions should continue to develop an educational approach

Financial institutions should further develop an educational approach which aims to 'tell a story' about their activities in a consistent and logical way – i.e. how the institution has performed and what its primary future risks are. Financial institutions should as far as possible use plain language, provide explanations of terminology (which can resolve possible ambiguity for the reader), ensure use of consistent terminology and consider the inclusion of summaries or synopses.

16. Financial institutions should clearly specify when not exposed to particular activities under stress where this information is likely to be decision-useful for users

Financial institutions should inform markets when they do not have significant exposure to activities under stress, if, this is likely to constitute decision-useful information for users. An explicit mention of a low or non-existent level of involvement may be important information for users if this may not already be clear and is, therefore, deemed relevant.