Feedback Statement

10/3

Financial Services Authority

Enhancing financial reporting disclosures by UK credit institutions:

Feedback on DP09/5

September 2010

FSA®

Financial Services Authority

Contents

1	Overview	7
	Purpose	7
	Background	7
	Key themes from responses	8
	Next steps	9
	International developments on CIs' disclosure	9
	Structure of this paper	10
	Who should read this Feedback Statement?	10
2	Feedback to questions in DP09/5	11
3	Our assessment of CIs' compliance with the draft BBA Code and their 2009 financial reporting disclosures	24
	Introduction	24
	Overview of the results of our assessment	24
	Risk disclosures	25
	Granularity	26
	Explaining all significant balances	26
	Disaggregating items with dissimilar characteristics	26
	Impairment methodology	26
	Valuation uncertainty	27
	Disclosures based on the 3-level hierarchy	27
	CVA methodologies (including monoline CVAs)	28
	Period averages, highs and lows	28
	Description and explanation of accounting policies used	28

Terminology 29

Location of disclosures 29

4 Changes to the BBA Code and our expectations for CIs’ 2010 financial reporting disclosures 30

The BBA Code for Financial Reporting Disclosure 30

Our dialogue with CIs concerning disclosure 30

Other changes 31

Scope 31

Disclosures in CIs’ 2010 annual reports 31

Issues arising from our review of 2009 annual reports 32

Loans subject to forbearance strategies 33

Changes in accounting methodology 33

Level 2 financial instrument measures 34

Accounting judgements relating to market conditions 34

Complex fair values 34

FSB’s Thematic Review on Risk Disclosures by Market Participants 34

Annex 1: List of non-confidential respondents

Annex 2: Final BBA Code for Financial Reporting Disclosure

This Feedback Statement reports on the main issues arising from DP09/5: *Enhancing financial reporting disclosures by UK credit institutions*.

Please address any comments or enquiries to:

Osman Sattar
Financial Services Authority
25 North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 9476
Fax: 020 7066 9477
E-mail: dp09_05@fsa.gov.uk

Copies of this Feedback Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

List of acronyms used in this paper

Bank of England's June 2010 *Financial Stability Report* (FSR)

Basel Committee on Banking Supervision (BCBS)

British Bankers' Association (BBA)

Committee of European Banking Supervisors (CEBS)

Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

Committee of European Securities Regulators (CESR)

Credit Institutions (CIs)

Credit Valuation Adjustments (CVAs)

Discussion Paper (DP)

Effective Interest Rate (EIR)

Financial Reporting Review Panel (FRRP)

Financial Stability Board (FSB)

Financial Stability Forum (FSF)

International Accounting Standards Board (IASB)

International Financial Reporting Standards (IFRS)

Interim Management Statements (IMS)

International Organisation of Securities Organisations (IOSCO)

Key Performance Indicators (KPIs)

United States Securities and Exchange Commission (SEC)

1 Overview

Purpose

1.1 In this Feedback Statement, we:

- summarise the feedback we received to the questions we raised in our Discussion Paper DP09/5: *Enhancing financial reporting disclosures by UK credit institutions*;[1]
- set out our response to this feedback; and
- discuss the next steps to continue enhancing disclosures by the UK's largest Credit Institutions (CIs).

1.2 We received thirteen responses from a range of CIs, accountancy firms, trade bodies and investors. We are grateful to those who took the time to respond. A full list of non-confidential respondents is set out in Annex 1 and copies of individual responses are available on request.

Background

1.3 We have previously observed that high quality disclosure by CIs is an important factor in fostering market confidence.[2] The onset of the financial crisis raised questions about financial reporting disclosures, particularly for complex financial instruments held by CIs. Some market participants were concerned – especially in the earlier stages of the financial crisis – that CIs' published accounting figures did not capture the reality of emerging problems, which damaged market confidence.

1.4 A wide range of other stakeholders including the House of Commons Treasury Committee, the Bank of England and the International Monetary Fund have also commented on CI disclosures or CIs' financial reporting in general.

1 We published this paper in October 2009 and it is available at www.fsa.gov.uk/pubs/discussion/dp09_05.pdf.
2 DP 09/2, *A regulatory response to the global banking crisis*, available at www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_02.shtml.

1.5 DP09/5 reflected on the issues arising from these and other factors, and set out potential ways to enhance CI disclosures. At the core of DP09/5 was the discussion of whether CI disclosures could be enhanced by using prescribed templates or by applying a voluntary code of disclosure, based on principles and supplementary guidance. In this regard, the British Bankers' Association (BBA) developed a draft Code for Financial Reporting Disclosure (the draft BBA Code, which we included as an annex in DP09/5) and the UK's largest CIs – Barclays plc, HSBC Holdings plc, Lloyds Banking Group plc, Nationwide Building Society, Santander UK plc (formerly Abbey National plc), Standard Chartered plc and The Royal Bank of Scotland Group plc – agreed to implement the Code in their 2009 annual reports.

1.6 DP09/5 also discussed and raised questions about other topics related to disclosure, including Pillar 3 reports, regulatory returns, standardised Key Performance Indicators (KPIs) and quarterly reporting.

Key themes from responses

1.7 The DP raised a number of issues and questions concerning CI disclosures, and sought responses. Overall, respondents:

- supported our interest in CI disclosures, as long as this does not cut across the work of accounting standard-setters and International Financial Reporting Standards (IFRS);
- agreed that market discipline is a significant factor in driving improvements in disclosure – but noted this must be supplemented by best practice guidance and encouragement from regulators and standard setters;
- agreed that comparability across CIs needs to developed through disclosure, with a caveat that comparability is not the same as uniformity;
- did not support the mandatory disclosure of period highs, lows and averages in addition to period-end (balance sheet) numbers;
- strongly supported the concept of a voluntary disclosure code for CIs, and suggested how it could be developed;
- did not support the concept of reporting templates;
- held mixed views regarding our primary focus on the annual report rather than Pillar 3 disclosures as a way to enhance disclosure and ultimately the operation of market discipline;
- did not support publishing regulatory returns;
- did not support applying standardised KPIs to all CIs; and
- did not support imposing a requirement for quarterly financial statements for CIs.

1.8 A more detailed analysis of respondents' feedback is set out in Chapter 2; this also includes our response to their feedback.

Next steps

1.9 In Chapter 4 we discuss the changes to the draft BBA Code which have been made in light of respondents' feedback and our assessment of CIs' 2009 disclosures (summarised in Chapter 3). We are pleased to note the seven CIs that voluntarily applied the draft BBA Code in their 2009 annual reports are planning to apply the final BBA Code on an ongoing basis. The final BBA Code is included in Annex 2.

1.10 Chapter 4 also sets out some of our current key expectations for disclosures in CIs' 2010 annual reports, which we will discuss further with the CIs during the autumn as part of the BBA Code's commitment to discuss disclosure matters.

1.11 As we noted in DP09/5, we will continue to assess CIs' public reporting, and expect tangible enhancements in the comparability and quality of their disclosures as a result of applying the final BBA Code. Based on this, we will keep the need for further policy initiatives to strengthen disclosure under review.

International developments on CIs' disclosure

1.12 We issued DP09/5 in October 2009, and since then CIs' disclosure has continued to be an important area of international focus. For example, in June 2010 the G20 finance ministers and central bank governors agreed that greater transparency of banks' balance sheet was an important element in making further progress on financial repair.[3]

1.13 In July 2010, the Financial Stability Board (FSB – previously the Financial Stability Forum, FSF) launched a peer review[4] of the implementation of the three recommendations made in the FSF's April 2008 report *Enhancing Market and Institutional Resilience*.[5] These recommendations focused on disclosure matters and are described below:

- dialogue with CIs about leading-practice risk disclosures to the public and the extent to which these firms made the identified disclosures in 2008 and subsequently;
- industry efforts to identify principles for useful risk disclosures, or to identify any specific additional recommended disclosures in the future; and
- steps taken or planned by supervisors to implement the Basel II Pillar 3 disclosure enhancements set by the Basel Committee on Banking Supervision (BCBS) in July 2009 by the end of 2010.

1.14 In Europe, the Committee of European Banking Supervisors (CEBS) continues to focus on CI disclosures in annual reports and Pillar 3 reports, and in April 2010 CEBS published its principles for disclosures in times of stress (*Lessons learnt from*

3 G20 Communiqué, Meeting of Finance Ministers and Central Bank Governors, Korea, 5 June 2010. Available at www.g20.org/Documents/201006_Communique_Busan.pdf.

4 FSB press release, date 21 July 2010. Available at www.financialstabilityboard.org/press/pr_100721.pdf.

5 Available at www.financialstabilityboard.org/press/pr_100721.pdf.

the financial crisis).[6] CEBS developed these principles based on its ongoing analysis of CIs' annual reports and Pillar 3 reports, and has stated they are intended to contribute to further improvements in the quality of disclosures. The principles are consistent with those set out in the BBA Code.

Structure of this paper

1.15 This paper is set out as follows:

- This chapter provides the background to this paper and an overview of the themes arising from the feedback we received to the questions we raised in DP09/5. It also summarises recent and possible future developments on CI disclosures.
- Chapter 2 sets out the feedback we received to the questions in DP09/5 in more detail, and includes our response to this feedback.
- Chapter 3 describes our assessment of disclosures in CIs' 2009 annual reports, focusing on the extent of compliance with the BBA Code and suggestions for enhanced disclosure made in DP09/5.
- Chapter 4 discusses the changes to the BBA Code, which were made in light of respondents' feedback and our assessment of CIs' 2009 disclosures. This chapter also sets out some of our likely key expectations for disclosures in CIs' 2010 annual reports.

Who should read this Feedback Statement?

1.16 This paper will be of interest to UK and international credit institutions and their trade associations, institutional investors, analysts, commentators, audit firms, accountancy bodies, financial regulators and standard setters.

6 Available at www.c-ebs.org/documents/Publications/Standards---Guidelines/2010/Disclosure-guidelines/Disclosure-principles.aspx.

2 Feedback to questions in DP09/5

2.1 This chapter summarises the feedback from respondents to all eighteen questions in DP09/5: *Enhancing financial reporting disclosures by UK credit institutions*, and sets out our response. Where the questions we raised in the DP are closely related to each other, we have grouped them together.

> Q1: Do you agree that it is appropriate for us to consider the issue of CI disclosures, and our rationale for doing so?

2.2 We received eleven responses to this question. All recognised we have a legitimate interest in CIs' disclosures and generally welcomed our desire to increase comparability and reduce complexity in CIs' financial reporting.

2.3 Respondents were clear that financial reporting disclosure requirements were the International Accounting Standards Board's (IASB's) mandate, including through its development of IFRS. Many respondents encouraged us to pursue our concerns by constructively inputting into the IASB's developments of IFRS, cautioning against any suggestions of a UK specific regime.

2.4 Two respondents indicated that greater granularity in disclosures may not be appropriate in financial statements. One commented that Pillar 3 disclosures may be the appropriate place for such disclosures, while the other suggested that greater direct prudential reporting (i.e. regulatory returns) was an appropriate way forward.

2.5 Another commented that any concerns about CIs' compliance with the IFRS reporting requirements should be referred to the Financial Reporting Review Panel (FRRP).

2.6 One respondent did not agree with the rationale set out in the paper and argued that the role of financial reporting in the financial crisis was overstated. This respondent suggested we focus our attention on improved regulation in respect of CIs' capital and liquidity requirements rather than financial reporting.

Our response

We are pleased to note that all respondents to this question were in no doubt that we have a legitimate interest in this area. We will continue our efforts to drive enhancements in CIs' financial reporting disclosures.

We fully agree that the IASB is the appropriate body to develop accounting standards and, as we noted in the DP, it is not our intention that any measures we may propose – whether through rules, best practice guidance or otherwise – should conflict with this. Moreover, we will continue to actively participate in European and international bodies which feed into the IASB's standard-setting process. These include the International Organisation of Securities Organisations (IOSCO), the European regulatory committees (CESR, CEBS and CEIOPS)[7] and the IASB's Standards Advisory Council.

In addition, we already meet regularly with the FRRP to discuss areas of mutual interest. As we recently explained in DP10/03 *Enhancing the auditor's contribution to prudential regulation*,[8] we also plan to enhance the way we and the FRRP share concerns and related information about individual firms' financial statements that emerge from our respective regulatory responsibilities.

On capital and liquidity, as described in *The Turner Review*,[9] capital, accounting and liquidity all have an impact on our objectives and we do not believe we should focus on some of these to the exclusion of others. We continue to be active internationally in developing new requirements for capital and liquidity through, for example, our work in the Basel Committee on Banking Supervision (BCBS), which at the end of 2009 issued a package of proposals to strengthen global capital and liquidity regulations for the banking sector, and is currently aiming to deliver a complete package of capital and liquidity reforms by November 2010.

Q2: Do you believe that market discipline is strong enough to ensure that appropriate improvements are made to CI public disclosures in a timely and consistent manner?

2.7 We received nine responses to this question. Most respondents stated their belief that, while market discipline is a significant factor driving the quality of public disclosures by CIs, this needs to be supported by accounting standards and encouragement to follow best practice identified by regulators. Several respondents identified the best practice guidance from the Senior Supervisors Group, *Leading-Practice Disclosures for Selected Exposures*,[10] as a good example of this encouragement. Some said that best practice codes can also help to achieve improvements in disclosure. One respondent highlighted the importance of also considering which disclosures could be reduced or removed so disclosures overall are more targeted and relevant.

2.8 One respondent took the view that market discipline on its own was insufficient, citing the market failure analysis set out in Chapter 5 of DP09/5, and in particular the economic argument about externalities, i.e. that private incentives for CIs to disclose information are too weak, resulting in less than optimal disclosures. This respondent argued that a combination of enhanced guidance and better enforcement of existing requirements is necessary for improved disclosure.

Our response

We broadly agree with respondents' views that market discipline benefits from accounting standards and encouragements to follow best practice, and we will continue engaging with CIs to encourage their efforts to enhance disclosure. As part of this, we have established

7 CESR: Committee of European Securities Regulators. CEBS: Committee of European Banking Supervisors. CEIOPS: Committee of European Insurance and Occupational Pensions Supervisors.

8 Available at www.fsa.gov.uk/pubs/discussion/dp10_03.pdf.

9 Available at www.fsa.gov.uk/pubs/other/turner_review.pdf.

10 Available at www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2008/ssg_exposures.shtml.

the Accounting Review Team (ART), a specialist team of experienced qualified accountants. ART's main role is to support supervisors on accounting and audit-related matters. As part of this, it continually reviews and analyses published financial statements and other financial information.

It uses the results of those reviews to provide supervisors with advice, insights and analysis about the firms they supervise and the sectors in which these firms operate, the transactions and other activities those firms are involved in, and the accounting judgements they have made. ART is now meeting with individual CIs to discuss matters relating to their accounting policies and disclosure.

Q3: Following our discussion on granularity, materiality and boilerplate disclosure and other sources of complexity in financial reporting, what elements of disclosure do you find most and least valuable, and why?

2.9 We received eleven responses to this question. Responses were wide-ranging, reflecting the nature of the question we asked. One CI respondent provided a useful insight of the feedback it had proactively sought from its investors about its financial reports. This indicated that investors valued:

i. being able to easily navigate through the financial report, by using sign-posting of disclosures and drill-down of balance sheet amounts more effectively;

ii. reducing the volume of disclosure where possible;

iii. the ability to compare between CIs;

iv. an emphasis on relevant risk information, with a focus on significant risks; and

v. forward-looking estimates of likely losses on higher-risk financial instruments.

2.10 Some of these points were echoed by others. Concerning (ii), two respondents felt it would be beneficial to reduce the volume of disclosures, while one respondent highlighted the need for management to proactively consider which disclosures could be removed from year to year (e.g. if the matters they related to were no longer material) to reduce the volume of reports. Similarly, another felt there was a risk that disclosures which may be relevant today become embedded and continue to apply even when users may no longer find them useful.

2.11 One accounting body favoured its proposal to make reports more readable, by creating short annual report and financial statements approximating 30 pages – summarising what a CI's management believe to be important, including a clear explanation of the business model and the key risks facing the CI – with the full annual report annexed to this document.[11]

2.12 Concerning (iii), many respondents agreed that greater comparability would be useful for stakeholders and supported the inclusion of a glossary of terms. Respondents generally favoured converging the definition of terms across CIs, although one respondent was sceptical that this could be achieved.

11 Institute of Chartered Accountants of Scotland, *Making Corporate Reports More Readable*. Available at www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf.

2.13 With regards to items (iv) and (v), some respondents commented that investors would welcome information on the entity's key risks and their sensitivity. One noted that investors are keen to understand the risks faced by CIs, including those relating to liquidity, and said users would prefer to see an improved presentation of information on such risks. Another respondent believed a significant amount of information on risk is disclosed in CI annual reports, but it is usually spread over different parts of the report. This respondent suggested that presenting risk information could be enhanced by including a short summary of information on the most important risks in one place, along with their sensitivity disclosures.

2.14 Another respondent also commented how disclosures about impairments are too dispersed in annual reports. This respondent noted that disclosures about managing risk and portfolio analysis is set out in the annual report's risk review section, while the accounting for impairment is summarised in the accounting polices note in the financial statements, and further analyses of provisions and credit risk are in other notes in the financial statements. As such, the respondent believed that CIs' disclosures about impairments could be improved by combining all component parts together, rather than expanding their content. Another respondent expressed the view that impairment disclosures could be enhanced by including a description of what constitutes an impairment trigger, as this would help comparing similar credit portfolios in different CIs.

2.15 Concerning granularity and materiality considerations for disclosures, respondents generally agreed with the points raised in the DP, recognising that judgement was necessary to achieve an appropriate balance between granularity and aggregation of information. Some respondents also cautioned against too much granularity, which could result in excessive levels of disclosure. Another respondent believed that the level of granularity should be higher the greater the level of management judgement applied to, and the risk arising from, the items being disclosed. This respondent also suggested that the rationale for the level of aggregation applied to disclosures should be explained.

2.16 Respondents who commented about Credit Valuation Adjustments (CVAs) generally felt that the disclosures about CVAs suggested in the DP were not always appropriate or necessary for all CIs, given the technical nature of the disclosure.

2.17 Respondents felt that disclosures concerning areas of significant judgement could be improved. They believed users should be able to understand the nature and effect of significant judgements that were made when preparing the financial statements. One respondent noted that the threshold of 'significance' had tended to be quite high.

2.18 Other views expressed included:

- To highlight valuation risks for level 3 financial instruments it would be helpful to use scenario analyses more and to disclose reasonably possible alternative inputs to valuations.
- For the sensitivity analyses of level 3 financial instruments, it would be helpful to include disclosure of the rationale for the level of aggregation applied by management. This is because these sensitivity disclosures are of particular

significance in times of decreasing liquidity or for an entity with significant exposure to illiquid instruments.

- Following feedback from users, an accounting body suggested that cash flow statements (required by IFRS) are less useful for CIs than for other types of company.

Our response

Respondents' views, as summarised above, have been helpful in further developing the principles and guidance of the final BBA Code, set out in Annex 2 and discussed further in Chapter 4. We note in particular that respondents:

- regard comparability as an important element of CI financial reporting;
- believe a glossary of terms, with convergence in definitions, would be helpful in achieving greater comparability;
- would like to see enhanced disclosure about significant risks, including sensitivity analyses;
- agree it is important reduce the volume of disclosure in some cases – as we stated in the DP, enhanced disclosure is distinct from more disclosure – and CIs should continue eliminating boilerplate and redundant disclosures; and
- would like disclosures to be more consolidated, so disclosures on one topic are in one place (or in fewer places) in the annual report.

We strongly encourage CIs to consider and address respondents' views (as summarised in this paper) as part of their work in developing the quality of their reporting.

Q4: Do you agree that there is a need to improve the comparability of CIs disclosure, and if so what would improve the comparability of information in CIs disclosures?

2.19 We received nine responses to this question, all of which agreed on the need for a greater degree of comparability between CIs. Using similar formats (e.g. by presenting quantitative data in tabular form) and similar locations for disclosure within annual reports were suggested as ways to facilitate comparability across CIs.

2.20 Concerning the latter point, some respondents noted that while a significant amount of risk information was presented in an annual report, it is spread over a number of areas and it could be helpful to congregate it in one place, supplemented by a summary.

2.21 Two respondents agreed that the extent to which disclosures form (or do not form) part of the audited financial statements should be made clear.

2.22 One respondent noted that there might be limits to the level of comparability that can be achieved given the different CI business models and risk exposures, as there is a difference between comparability and uniformity.

2.23 Overall, respondents believed that enhanced comparability can be best achieved by CIs working together through industry forums, such as the BBA, under a principles based code. As in the responses to Question 1, some respondents agreed that forming a single set of defined terms through a glossary would greatly improve consistency and comparability; however others, while supportive of a glossary, were sceptical that it is possible to converge definitions across CIs.

Our response

We are pleased to note that respondents agreed on the need to improve the comparability of CIs' disclosure. We believe that many of the suggestions made (including those summarised above) can, and should, be addressed as part of the effective application of the finalised BBA Code for Financial Reporting Disclosure.

We agree that including a glossary of terms within CIs' annual reports that are not defined in IFRS is helpful for users. As we stated in the DP, we believe that, over the medium term, these definitions should be substantively converged across CIs to enhance comparability and understanding.

> Q5: Do you believe that disclosure of period averages and highs and lows by CIs would be useful, and if so, for which particular asset and liability classes? How would you find this useful?

2.24 We received nine responses to this question. Most respondents took the view that a mandatory requirement for such disclosures for all CIs would increase the complexity without necessarily enhancing comparability or understanding, and therefore would not be useful. Respondents agreed with IFRS[12] 7, *Financial Instruments: Disclosures*, which states (in paragraph 35) that appropriate additional disclosures should be made where information at the reporting date is unrepresentative of risk exposures during the year.

2.25 Respondents also noted that CIs registered with the US Securities and Exchange Commission (SEC) must disclose average balance sheets under SEC requirements.

2.26 One respondent noted that period average balance information can be useful for volatile balances (e.g. a CI's trading book balances), but that further guidance on the methodology for calculating averages may be needed.

Our response

From our review of the 2009 annual reports of the seven CIs that applied the BBA Code, we note that six already disclose average balance sheet information and various types of average net income information, although none disclosed period highs and lows. When the requirements in paragraph 35 of IFRS 7, *Financial Instruments: Disclosures*, apply, we encourage CIs to use the BBA Code to develop disclosures that would allow greater comparability across CIs, and consider whether further disclosure of period highs and lows might be helpful to users.

In this regard, it is worth noting that the Bank of England's June 2010 *Financial Stability Report*[13] (FSR), reiterates the Bank's view that there is a need for better disclosure in respect of period averages, highs and lows. The FSR notes that:

(i) existing disclosure generally consists of information about average values of basic balance sheet items, with no regular information on intra-period highs and lows; and

12 IFRS: International Financial Reporting Standard.

13 The Financial Stability Report (FSR) is available at the Bank of England website, www.bankofengland.co.uk/publications/fsr/2010/fsrfull1006.pdf. Box 8 of section 5 of this FSR discusses intra-period information.

(ii) these disclosures are not sufficient to allow comparisons across institutions or jurisdictions.

Q6: Do you support the concept of a disclosure code for CIs and if so, should such a code be applied to the largest CIs only, or more widely?

Q7: Do you believe that the BBA Disclosure Code as set out in Annex 2 will enhance the quality of disclosures and the ability to compare across the participating CIs?

Q8: Do you have comments on particular aspects of the BBA Disclosure Code, especially on how it can best be expressed in order to fulfil its purpose?

2.27 We received eleven responses to Question 6, and eight responses each to Questions 7 and 8.

2.28 All respondents supported the concept of a disclosure code for CIs. One believed we should try to collaborate with the IASB to internationally adopt and apply the BBA Code to promote international convergence and comparability for financial reporting disclosures.

2.29 We received a variety of responses to the second part of Question 6 (whether a disclosure code should be applied to largest CIs or more widely):

- Two respondents believed a code should be voluntary for all CIs.
- One said a code should apply to all CIs, with the proviso that smaller entities should only report items applicable to them.
- Four respondents expressed the view that a code is more relevant to large CIs and it should only apply to them. One suggested it should be voluntarily available to all CIs, while another suggested that extending it to a broader population of CIs could be considered after the code had been established and there had been time to assess whether the desired improvement in disclosure had been achieved.

2.30 All respondents to Question 7 agreed that the BBA Code is an important step in enhancing financial disclosures by CIs in the UK and that it has the clear potential to enhance the quality and comparability of CI disclosures.

2.31 Respondents stated that applying the BBA Code enables CIs to adapt disclosures in response to a changing environment and to reflect emerging issues. The BBA Code will help CIs to provide high quality and meaningful disclosures to users, as well as facilitate comparability across credit institutions.

2.32 With regard to Question 8, three respondents said the BBA Code should state more clearly that it applies to the whole annual report rather than just the financial statements. One respondent also commented that the BBA Code could be further supported by more detailed and specific guidance concerning the areas which lead to the widest divergence in practice.

2.33 Many respondents emphasised that the BBA Code's five over-arching principles, taken together with the agreed approach for an ongoing process to meet and discuss financial statement disclosures (through the BBA Disclosure Working Party), provide a strong foundation for the BBA Code. Respondents encouraged us to continue our dialogue with the BBA to strengthen the implementation of the BBA Code.

Our response

We note the widespread support for a disclosure code from respondents, and the variety of responses in relation to the (un-asked) question about mandatory application of such a code. To be clear, it is not our present intention to mandatorily impose a disclosure code through FSA rules, especially as the UK's seven largest CIs applied the draft BBA Code in their 2009 annual reports, and plan to apply the final version from their 2010 annual reports.

This represents the CIs' commitment to continue enhancing their disclosures, which will contribute to further developing the UK CIs' reputation for high quality public reporting. This is also helpful for our statutory objectives of market confidence and financial stability.

That said, as we noted in DP09/5, we will continue to assess CIs' public reporting and expect tangible enhancements in the comparability and quality of their disclosures as a result of applying the Code. Based on this, we will keep the need for further policy initiatives to strengthen disclosure under review.

With regard to applying the BBA Code more widely, our view is that:

- other CIs in the UK may also wish to apply the Code voluntarily, but we will not actively seek a commitment from them to do so; and
- we will support the CIs and the BBA seeking to raise awareness of the Code internationally.

One of the key strengths of the BBA Code is the establishment of the BBA Disclosure Working Party, as it provides an explicit mechanism for CIs to meet to discuss disclosures and comparability matters. This is an effective method to ensure that the spirit and intentions of the Code are not lost, and that the Code is kept updated as necessary.

We meet regularly with the BBA; this includes the BBA's Financial Reporting Advisory Panel, comprised of group chief accountants from major UK CIs, and we are committed to continuing our dialogue about disclosure matters with them.

Q9: As an alternative to a disclosure code, do you support the FSA developing mandatory disclosure templates for CIs?

2.34 We received twelve responses to this question, none of which supported mandatory disclosure templates. Many respondents argued that prescriptive templates:

- tend to promote a 'checklist' mentality, as they are mechanical and standardised – this may discourage management from actively reassessing the appropriateness of disclosures each time financial statements are prepared and from providing timely disclosures in response to emerging issues;
- do not take into account differences in business models;
- could make financial reporting less useful by making different things look the same; and
- may unnecessarily expand disclosures for immaterial items.

Our response

We recognise respondents' views as some of the potential drawbacks to a template approach. While we believe that these drawbacks are not necessarily insurmountable, we recognise that developing the templates, and ongoing compliance with these templates by CIs, will probably require CIs and us to commit considerable resources. Given that the larger CIs plan to implement the finalised BBA Code, we do not propose to pursue this idea further at present. As noted in our response to Question 8, we will keep the impact of the BBA Code under review and continue to assess the need for further policy initiatives to strengthen disclosure.

Q10: What benefits (including ones not specifically identified above) would you expect to flow from any new disclosure arrangements? We would particularly value indications of the extent of these benefits.

Q11: Do you believe that significant costs (other than compliance costs) could arise from initiatives to secure better disclosure? If so, what are these costs, and how significant could they be?

Q12: What compliance costs do CIs expect to incur under any new disclosure arrangements (for example, those set out in Chapter 4)? Please provide broad quantitative estimates of their possible magnitude.

2.35 We received eight responses to Question 10, five responses to Question 11 and three responses to Question 12. The benefits suggested by respondents included:

- increased market confidence;
- improved transparency of CIs;
- a benefit to investors in ensuring that disclosures set out information clearly and accessibly, so CIs are more easily comparable;
- a greater focus on identifying and articulating the risks affecting financial statements at the reporting date; and
- an enhanced understanding of the possible impacts on CIs in stressful situations.

2.36 Most respondents re-emphasised that they do not believe a new mandatory disclosure regime is necessary or could provide a complete solution to the market failure issues the DP identified.

2.37 While no respondents attempted to quantify additional costs from enhanced disclosure, they suggested that firms will incur significant additional costs (including compliance and assurance costs) if disclosure templates were mandated. Many pointed out that it will be less costly and more effective to implement the draft BBA Code, which is a principles-based approach, rather than a prescriptive template approach.

2.38 The three responses we received for Question 12 focused on compliance costs in the context of mandatory disclosure templates rather than other options. The responses indicated that it is not currently possible to objectively quantify additional costs

– the complexity of templates, CIs' size and nature of business and whether the data required to complete templates exist within CIs' current systems were given as examples of possible drivers of costs.

2.39 Many respondents suggested that systems and processes will need to be established if data necessary to complete mandatory templates is not currently available or collected by firms. This in turn will lead to additional internal staff costs for collecting and reporting data, as well as costs to modify or replace software and increased audit fees to audit the information.

Our response

We agree with the benefits that respondents identified and, as noted in our response to Question 9, we recognise that a template approach is likely to be more costly than a code approach.

Q13: Do you agree that our primary focus should be on disclosure in CIs' annual reports generally, rather than disclosures under Pillar 3?

2.40 We received nine responses to this question. Two respondents agreed with the question, (i.e. that it was right for us to primarily focus on annual reports), and a further two stated that it was important to consider both annual reports and Pillar 3 disclosures. Conversely, three respondents disagreed with the question, saying we should solely focus on Pillar 3 disclosures.

2.41 The remaining two respondents took the view that Pillar 3 may be a more appropriate focus for us as a prudential regulator, while one recognised that we have a valuable role in providing informed comment on the quality of CIs' financial reporting disclosures.

2.42 Echoing the responses we received to Question 1, respondents noted that accounting standard setters (e.g. the IASB) are best placed to judge the appropriateness of disclosures in annual reports. One respondent noted that, if initiatives to improve external financial reporting are led by prudential regulators, the resulting reporting requirements may not remain focused on investor needs.

Our response

As we set out in the DP, the annual report is considered to be one of the most important and comprehensive sources of corporate information, and is a key element for the operation of market discipline. It is worth repeating here that '[a]t the top of every analyst's list (of financial reports used by analysts) is the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary or supplementary to it'.[14] As such, we continue to strongly believe that it is right for us to have a focus on the annual report when considering ways to enhance CI disclosures.

That said, Pillar 3 is a relatively new reporting requirement and we believe Pillar 3 reporting will, over time, become increasingly useful to CIs' stakeholders. In the past we have actively fed into the development of Pillar 3 disclosures through, for example, CEBS's review of

14 Knutson, P (1992), *Financial Reporting in the 1990s and Beyond*, Association for Investment Management and Research.

banks' Pillar 3 disclosures,[15] and we intend to continue these activities. In our recent paper, DP10/3 *Enhancing the auditor's contribution to prudential regulation*,[16] we also ask whether the external audit of Pillar 3 disclosures would enhance the usefulness of such disclosures for users.

Q14: If CIs and other CRD firms were required to disclose certain prudential returns, which returns would you currently consider most relevant for publication and why?

Q15: Are there any particular difficulties that such a publication might bring?

Q16: What do you consider would be the additional costs involved in public disclosure of such returns?

2.43 We received seven responses to Questions 14 and 16 and nine responses to Question 15. Only one respondent directly addressed the specific point in Question 14, by stating the specific prudential returns that might be considered relevant for publication. These were FSA003 (capital adequacy), FSA004 (credit risk). FSA045 (IRB portfolio risk) and FSA046 (securitisation), with the caveat that some of the data in these returns is confidential and thus inappropriate for publication. The respondent also noted that much of this information is already set out in Pillar 3 disclosures, sometimes in more granular detail than in the prudential returns.

2.44 The respondent also pointed out that FSA001 (balance sheet) and FSA002 (income statement) would not be relevant for public disclosure, as they are prepared on a regulatory consolidation basis rather than an accounting consolidation basis, and thus are likely to confuse (rather than inform) financial statement users.

2.45 Respondents did not support public disclosure of any prudential returns. The rationale given varied, but included:

- confidentiality or commercial sensitivity of information contained in prudential returns – for instance, one respondent said that named institutions are required in certain large exposure reports;
- the risk of stakeholders being overwhelmed with exponentially increased volume of data released at a given point in time;
- the fact that the data in each return would require explanation and reconciliation with other published data, such as the financial statements; and
- these elements increased the risk of published returns being misinterpreted, which would likely lead to a decline of market functionality.

2.46 Most respondents believed that expanding the Pillar 3 disclosures would be the appropriate route for including additional information contained in prudential returns into the public domain, and some claimed that most relevant data is already available through Pillar 3 disclosures in an appropriate form.

15 The latest report from CEBS on banks Pillar 3 disclosures is available at www.c-ebs.org/documents/Publications/Other-Publications/Others/2010/Transparency_Pillar3.aspx.

16 Available at www.fsa.gov.uk/pubs/discussion/dp10_03.pdf.

2.47 One respondent also stated that many prudential returns include a significant amount of statistical information that is not relevant to financial reporting and that forward looking information – published in a number of returns – would not be appropriate for disclosure.

Our response

Consistent with respondents' comments, we do currently not envisage publishing individual CIs' regulatory returns. That said, we will keep this decision under review, particularly concerning any impact from the changes to regulatory returns across Europe. As we noted in the DP, CEBS is developing a Common Reporting Framework (COREP) to develop consistent pan-European regulatory reporting. CEBS published its proposals for COREP in June 2010 and it has not yet expressed any appetite to publish firms' prudential returns data.

Q17: Would you support the publication of KPIs in a similar manner to Denmark?

2.48 We received eight responses to this question, none of which supported the idea raised in the question. Respondents said CIs should provide information about those key performance indicators (KPIs) which management use to manage the business, rather than a prescribed set of KPIs. That is, KPIs are only useful if management use them in overseeing the business – it would not be useful to disclose KPIs that management do not use.

2.49 However, two respondents suggested that convergence in the definition of terms used by CIs would be helpful and should be encouraged, as it would allow users to construct their own KPIs and ratios and make meaningful comparisons across CIs. One respondent noted that the use of standardised KPIs in Denmark is based on a common definition of terms, and observed that applying common terms allows the market to select the most relevant ratios to apply, thus negating the need for defined KPIs.

Our response

We accept the points raised by respondents, and we agree that a drive towards convergence in the definition of terms used by CIs (discussed in Question 4) would aid comparability across CIs.

Q18: Do you agree with our view that imposing additional rules for CIs' IMS reporting, such as a requirement for quarterly financial statements, is not desirable?

2.50 We received six responses to this question. All respondents agreed that imposing further mandatory rules for Interim Management Statements (IMS) reporting, such as a requirement for quarterly financial statements, is undesirable and that individual firms are best placed to consider the approach they take to their IMS reporting.

2.51 Respondents believe that the current requirements under the Transparency Directive for IMS reporting are sufficient. Respondents felt that a mandatory imposition of quarterly reporting for CIs would not significantly enhance public information, as material changes are already required to be disclosed under the Transparency Directive, and additional compliance costs are likely to be greater than any perceived benefit.

Our response

We note that respondents agree with the views we expressed in the DP and we do not propose any further action at this time.

3 Our assessment of CIs' compliance with the draft BBA Code and their 2009 financial reporting disclosures

Introduction

3.1 During summer 2010 we conducted an initial assessment of the disclosures provided in the annual reports of CIs that undertook to apply the draft BBA Code. In particular, we reviewed the annual report disclosures against the draft BBA Code and the more detailed disclosures suggested in DP09/5. We discussed the results of the initial assessment with each CI individually to better understand the materiality of the issues involved and the thinking that lay behind the disclosures provided. We then revised our assessments in the light of what we learned during these discussions. In this chapter we summarise the conclusions we reached as a result of this work.

3.2 We wish to express our gratitude to the finance teams at the CIs who helped us improve the quality of our assessments and for the time they spent assisting us in this work.

Overview of the results of our assessment

3.3 The draft BBA Code's background section says that the firms which have agreed to adopt it (the UK's seven largest lending institutions) must include a statement of compliance with the draft BBA Code in their annual and interim reports, beginning from their 2009 annual reports. All seven CIs stated in their 2009 annual reports that they had complied with the draft BBA Code.

3.4 The draft BBA Code then sets out high-level principles that call for:

- high quality and meaningful disclosures that help users to understand the financial position, performance and changes in the business' financial position;
- a commitment to improve the disclosures provided, including the comparability of disclosures across the UK banking sector, on an ongoing basis;
- a willingness to assess the applicability and relevance of good practice guidance and recommendations issued from time to time by regulators and standard-setters; and
- clear differentiation of audited information from unaudited information.

Our assessment was that in their 2009 annual reports the seven CIs complied with these high-level principles.

3.5 However, there remains room for further improvement, which should come as no surprise as the principles themselves call for continual improvement. We believe the following areas can be improved in the near future:

- **The comparability of the information provided.** CIs do not organise themselves in the same way, so the information they use to manage themselves and which they believe best 'tells the story' of their financial activities and financial position varies from institution to institution. CIs also often differ as to the most appropriate way of presenting information. Therefore users can find it difficult to compare the financial information CIs provide; i.e., to discern and evaluate similarities in, and differences between, the nature and effects of two CIs' financial activities and position. However, users are becoming increasingly keen on comparable financial information about CIs. We believe CIs could do more – in terms of terminology, explanation, presentation and methodology – to make their financial information comparable.
- **The ease with which information in the annual report can be found, understood and used.** Large CIs are complex entities and many transactions they undertake are also complex. Consequently their annual reports are long and in parts a difficult read. However, it is still important to present the information in a user-friendly way. We believe CIs can do more in this area, particularly in terms of the location of the information provided.

3.6 The DP also contained several detailed suggestions about potential enhancements to existing disclosures. In many of the areas involved the seven CIs' annual reports provided very comprehensive disclosures; however, in a few areas the disclosures provided were a little thin, even though the issue involved was material. We recognise that a balance has to be struck between users' desire for more granularity and the need for a fair degree of aggregation to make the annual report's length manageable, but we believe this balance may not always have been struck in exactly the right place.

3.7 Our detailed findings across the seven CIs as a whole are set out in the remainder of this chapter.

Risk disclosures

3.8 The DP stated that there is some evidence across all industry sectors – not just financial services – that the disclosures regarding principal risks and uncertainties tend towards being boilerplate. It suggested that the disclosures should include for each principal risk:

- the nature of the risk;
- the impact on the CI were the risk to crystallise;
- how that risk is managed; and
- the extent of the possible or actual exposure.

We believe CIs have generally provided reasonable disclosures in these areas, although it was difficult to assess the adequacy of disclosures about off-balance sheet arrangements. Also, as explained in Chapter 4, we are giving further thought to the disclosures that may be expected in relation to certain risks that arise from complex products.

Granularity

Explaining all significant balances

3.9 We suggested in the DP that, when considering the appropriate level of granularity to provide in disclosures, information should be disaggregated so significant balances are always explained. Our assessment was that all significant balance sheet items have been explained in the financial statements. Furthermore, any analysis provided in the financial statements of assets and liabilities was generally reconciled back to the numbers in the primary financial statements.

Disaggregating items with dissimilar characteristics

3.10 The DP also suggested it might be useful to disaggregate items with dissimilar characteristics; for example, loans by risk characteristic. We suggested this for two reasons:

i. it is more difficult to use numbers that are an aggregation of dissimilar items because the aggregation process in such circumstances will usually result in a loss of information.

ii. aggregations CIs use will be different, so disaggregating items with dissimilar risk characteristics is a way of enhancing the comparability of the information provided.

3.11 However, CIs generally did not disaggregate items to the extent that was perhaps envisaged in the DP. For example, the loan portfolios disclosed contained loans with differing characteristics. We recognise that a balance needs to be struck between the need for disaggregated information and the need to prevent CIs' annual reports becoming too long. However, we know it is difficult with some of the current disclosures to make meaningful comparisons in some areas. As users need to compare material items which are alike, and understand when material items are not alike, we think the balance has not been struck in exactly the right place.

Impairment methodology

3.12 The DP also suggested that, for financial assets that have been assessed for impairment on a collective basis, there should be, for each distinct portfolio, disclosure of the impairment methodology applied and the specific loss event triggers. A similar level of granularity was suggested for disclosures about the types of loss event considered when assessing the impairment of individually significant loans. However, the disclosures provided tended to be provided on a more aggregated basis.

3.13 Once again it is necessary to find the right balance between granularity and length of disclosures. We consider this balance was not always struck in the right place. For example, we noticed that some CIs list several types of loss event when assessing the impairment of individually significant loans, but do not explain whether some are relevant for only certain types of loan. We also noticed that there were material differences in the impairment methodology used in different portfolios, but the methodology was explained at such a high level that this was not apparent. (In some cases the explanation was at such a high level it was little more than boilerplate disclosure.) We believe these disclosures could be enhanced without significantly increasing the length of disclosures.

Valuation uncertainty

Disclosures based on the 3-level hierarchy

3.14 The DP explained that, to be understandable, information about the methodologies and key inputs used to value level 3 financial instruments needed to be disclosed with sufficient detail and appropriate aggregation. Our assessment was that this generally was done.

3.15 For fair value measurements in level 3, where changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, IFRS[17] 7 *Financial Instruments: Disclosures* requires disclosure of this fact and the effect of those changes. The entity is also required to disclose how the effect of a change to a reasonably possible alternative assumption was calculated. The DP suggested that, while the effect of such changes can be made on a combined basis, it can also be useful to disaggregate the effect of each significant input. The DP suggested it would also be important to disclose interdependencies between inputs and/or across products where relevant. Our assessment was that:

- CIs sometimes provided insufficient disaggregation to understand the effect of each significant input, even though some of the inputs appeared to be individually material.
- Relatively little information was provided about interdependencies. Although we recognise interdependencies can be complex, the user clearly needs the existing disclosures enhanced. We note that the IASB has recently issued an exposure draft proposing enhancements to the existing disclosure requirements in this area (ED 2010/7 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements)*.

3.16 The DP also suggested that, where level 2 financial instruments comprise a significant proportion of the financial assets and liabilities measured at fair value, it would be useful to include additional disclosures concerning the valuation of the instruments, particularly if categorisation between level 2 and level 3 was marginal. In general, relatively little additional disclosure was provided by CIs in this area, primarily because for them, categorisations between level 2 and level 3 were not difficult.

17 IFRS: International Financial Reporting Standard.

CVA methodologies (including monoline CVAs)

3.17 The DP suggested that detailed qualitative disclosures about CVA methodology and the reasons for it should be provided. We believe these disclosures were provided although not much disclosure was provided about sources and the robustness of key market information. However, we believe there is room for further improvement in the descriptions and explanations of CVA methodologies adopted. In some cases the terminology used is different from entity to entity, and important aspects of the methodology were sometimes implied rather than explicitly explained.

3.18 The DP also suggested that the qualitative disclosures (discussed above) should be supplemented by quantitative disclosures setting out the current balance sheet adjustments with comparative data. However, the quantitative disclosures provided were generally relatively sparse.

3.19 Materiality was a factor for some CIs. However others were more concerned that they would need to provide very detailed and/or technical disclosures which would probably be of little use to most users.

Period averages, highs and lows

3.20 The DP noted that an entity's balance sheet represents a snapshot of its financial position at a point in time, and it discussed the desirability of supplementing that snapshot with information about period averages and/or period highs and lows. It also observed that 'a number of the UK's largest CIs already present average balance sheets and average net income information in their annual reports' and our review revealed this continued to be the case. Some CIs also provided disclosures about period high and low risk exposures. Others said their balance sheet was sufficiently representative of the position at other times that disclosures about period averages, highs and lows would add little useful information, although they generally have not explained this in their financial statements.

Description and explanation of accounting policies used

3.21 The DP expressed the concern that CIs' descriptions and explanations of the accounting policies they have used commonly contained boilerplate language. It expressed the view that CIs need to include narrative that reflects how they apply the accounting methodologies described in the disclosures. In particular the DP said reasons should be given to clarify why CIs choose a particular accounting policy.

3.22 We believe most CIs have largely avoided using boilerplate language in their accounting policy disclosures. However, we consider that, although CIs often explained reasonably well *what* they had done, they were less good at explaining why they had done it. For example, in valuations, although CIs described the methodology selected, we thought it would have been useful to explain also why that methodology was selected; in other words, to explain what hurdles the entity has to clear to meet the objectives of IFRS etc., and how the methodology they chose helped them to clear those hurdles.

Terminology

3.23 The DP noted that, when providing more granular disclosures, CIs often need to use terminology which the annual report users may not understand (as it does not occur or is not defined in IFRS). The DP suggested it was important that each CI includes a glossary defining the terms used to classify exposures and risks. The DP also gave our view that applying clear, converged definitions would improve the usefulness of financial statements, and it suggested that the objective, over the medium-term, should be to substantively converge the terminology and definitions across the CIs.

3.24 All the CIs provided a glossary of terms in their 2009 reports. However, while the DP envisaged a two-step process in which the first step involved comprehensive glossaries being provided and the second step involved increasing the convergence of terminology and definitions, the tendency seemed to be more towards including terms in the glossary only if their meaning had been substantively converged across the CIs. Therefore, the glossaries were not as comprehensive as we had hoped they would be. We understand that converging all terminology used is not achievable in the short-term; however, we believe comprehensive glossaries are desirable and achievable in the short-term.

Location of disclosures

3.25 The DP discussed the location of disclosures. Firstly it explained how financial instrument disclosures tend to be spread across a number of areas in the annual report, perhaps including several notes to the financial statements and the Business Review. The DP noted that, although there are often good reasons why this is so, it makes it more difficult for users to find all disclosures relating to one particular issue. This is exacerbated by different CIs choosing different locations for the same types of disclosures. The DP suggested that these difficulties impeded the comparability and usability of the information. We believe this area can, and should, be improved. In the short-term, comprehensive cross-referencing and a detailed index might be the easiest way of achieving improvement, and in the longer-term greater convergence of practice and bringing more of the disclosures together, even if this means some duplication, is probably necessary.

3.26 Secondly the DP emphasised the importance of ensuring that audited and unaudited information in the annual report should be clearly distinguished from each other. Although the CIs disclosed which information was audited and which was not, this was not done clearly by all for a reader ‘dipping into’ the annual report. We believe it should be clear regardless of how the annual report is being used.

4 Changes to the BBA Code and our expectations for CIs' 2010 financial reporting disclosures

The BBA Code for Financial Reporting Disclosure

4.1 As noted earlier, DP09/5 included the draft BBA Code as an annex to that paper. The BBA developed the draft BBA Code with significant input from us. It was voluntarily applied by the UK's largest CIs in their 2009 annual reports (see Chapter 3 for our assessment of the CIs' 2009 disclosures in light of the draft BBA Code's aims and other matters highlighted in DP09/5).

4.2 The draft BBA Code was presented as a draft code at the time of publishing DP09/5 in recognition of the fact that it may need to be revised in light of the responses to questions raised in the paper. As set out in Chapter 2, respondents supported the concept of a disclosure code and provided some valuable insights. Below we set out the changes that have been made to the BBA Code following respondents' feedback and our assessment of the disclosures in CIs' 2009 annual reports. The final BBA Code is included in Annex 2.

Our dialogue with CIs concerning disclosure

4.3 As noted in Chapter 2, respondents encouraged us to continue our dialogue with CIs concerning disclosures. And the CIs themselves recognise that we have a legitimate interest in encouraging enhanced disclosures.

4.4 The draft BBA Code established a process for the CIs to consider areas of topical interest that may have an impact on their financial reporting disclosures, and agree a common approach to addressing these areas in their disclosures. The process also committed CIs to discuss and agree ways in which their disclosures could enhance the ability to make comparisons across the sector, to discuss applying new IFRS disclosure standards and to consider best practice guidance produced by regulators.

4.5 The final BBA Code adds to this process by including an explicit commitment for the CIs to meet regularly with us – for example well in advance of CIs' interim and annual reporting periods – so we can communicate our views on areas of relevant disclosure points and related matters for that reporting period. This provides an opportunity for CIs to consider and debate any issues raised and amend their disclosures, or discuss any areas of disagreement with us.

4.6 We are committed to engaging fully in this process and strongly believe this type of dialogue will drive continuing enhancements in CI disclosure and a greater mutual understanding (between the CIs and us) of key areas of interest and importance.

Other changes

4.7 The other changes to the final BBA Code primarily reflect changes to ensure the text does not become out of date over time. For example, under principle 3 of the draft BBA Code there was reference to 'current examples of best practice disclosure' – this has been omitted in the final BBA Code. The process set out in the final BBA Code, under which the CIs meet (among themselves and with us) to discuss disclosure practices will help ensure relevant best practice examples are actively considered.

Scope

4.8 The CIs that voluntarily applied the draft BBA Code in their 2009 annual reports plan to apply the final BBA Code in their future annual and interim reports on an ongoing basis, and include a statement of compliance in their annual reports. These CIs are the groups headed by:

- Barclays plc;
- HSBC Holdings plc;
- Lloyds Banking Group plc;
- Nationwide Building Society;
- Santander UK plc (formerly Abbey National plc);
- Standard Chartered plc; and
- The Royal Bank of Scotland Group plc.

4.9 We believe that this demonstrates the CIs' ongoing work to continually enhance disclosures. We would welcome other CIs also applying the BBA Code (again, on a voluntary basis), although we will not actively seek a commitment from them to do so. We believe that over time, the best practices that will emerge from the largest CIs applying the Code will spread to other CIs, in the UK and internationally.

Disclosures in CIs' 2010 annual reports

4.10 As explained above, the final BBA Code makes it clear that CIs will meet with us so we can communicate our views on areas of relevant disclosure points and related matters for that reporting period. This will include a discussion of the issues that either the CIs or us (or both) regard as the 'hot topics' for the coming reporting season. To indicate what this might involve, we have set out issues – in no particular order – we believe may be among the hot topics for the 2010 reports in the remainder of this chapter. We intend to discuss these issues further with the CIs applying the BBA Code before finalising our views.

Issues arising from our review of 2009 annual reports

4.11 In Chapter 3 we discussed the results of our review of disclosures in the seven CIs' 2009 annual reports. We hope that 2010 will see a further improvement in the financial instrument disclosures provided, particularly in the following areas:

- Comparability of information provided. We believe CIs could do more – in terms of terminology, explanation, presentation and methodology – to make their financial information more comparable. In particular:
    - o CIs should provide comprehensive glossaries of key terms, even if the CIs have not yet converged their definitions of those terms. Further progress should also be made to substantively converge the terminology and definitions across the CIs.
    - o We are looking for CIs to develop ways to enhance the comparability of the information they provide about the risk characteristics of their loan portfolios. Possible ways include disaggregating the portfolios more or standardising the types of loans that are aggregated.
    - o We are also looking for CIs to develop ways of enhancing the comparability of the disclosures they provide about impairment methodologies, including specific loss event triggers, so the methodologies adopted can be understood and material differences can be identified and taken into account. As explained in the DP , '[f]or assets that are reviewed for impairment on a collective basis, we believe that disclosure of the impairment methodology applied and the specific loss event "triggers" considered for each distinct portfolio can provide helpful information to users. Also, disclosure about the types of loss events that are considered when assessing individually significant loans and groups of assets for impairment can provide more insight where there is an appropriate level of granularity'.
- The ease with which information included in the annual report can be found, understood and used. We believe CIs can do more in this area. In particular:
    - o In the short-term, comprehensive cross-referencing and a detailed index could overcome the difficulties created for users by spreading disclosures throughout the annual report and by different CIs locating their disclosures differently. Over the longer-term, CIs could work together to achieve greater convergence of practice and more disclosures could be brought together, even if this means some duplication.
    - o Audited information in the annual report could be more clearly distinguished from unaudited information so that a reader 'dipping into' the annual report can easily distinguish between the two.
- The disclosures provided about the impact of interdependencies between inputs to fair value measures, particularly if there is any delay in the IASB developing comprehensive requirements.
- The clarity and completeness of the detailed qualitative disclosures about CVA methodology, and the extent of the related quantitative disclosures.

- The explanations given about why a particular accounting policy or methodology has been chosen.

Loans subject to forbearance strategies

4.12 We believe the accounting treatment of, and disclosures about, loans subject to forbearance strategies will be an important issue in 2010 annual reports. Such strategies include (but are not restricted to) extending loan terms, payment holidays, temporarily lowering interest rates, converting loans to an interest-only basis, and capitalising loan arrears. As noted in our recent Financial Risk Outlook and the recent joint Discussion Paper published by the FSA and the Financial Reporting Council (DP10/3 *Enhancing the auditor's contribution to prudential regulation*), using forbearance strategies is currently mutually beneficial to the lender and the borrower and, as a result, such strategies are being used much more extensively than before.

4.13 However, it appears CIs do not necessarily see loans subject to forbearance strategies as 'impaired loans' and do not necessarily consider them to be in arrears or 'past due' under their renegotiated terms, even if these terms are inconsistent with the original contract. Therefore, this suggests that loans subject to forbearance strategies might not fall within any of the IFRS-mandated specific disclosures. In addition, although IFRS 7 *Financial Instruments: Disclosures* currently requires (in paragraph 36(d)) disclosure of 'the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated', difficulties around assessing which loans subject to renegotiation 'would ... be past due or impaired' could mean there would be no disclosure under that requirement either. Therefore, it could be argued that there are no specific disclosures mandated in this area. Bearing this in mind, the risk is that no disclosures are provided or that those provided are insufficient or may vary from entity to entity.

4.14 A similar risk exists in relation to wholesale lending, where loans have been restructured to take into account current market stresses. There is a risk that such loans may also fall outside the mandated disclosure requirements of IFRS 7, for the reasons listed earlier.

Changes in accounting methodology

4.15 There are some signs of a possible increase in the number and impact of changes made to methodologies used in arriving at various accounting estimates; for example in an entity's loan impairment methodology (e.g. roll rates or emergence periods) or in the way some fair values are estimated. Disclosing such changes is mandated by IFRS 7 (paragraph 33(c)), which requires that, for each type of risk arising from financial instruments, disclosure of, among other things, the methods used to measure the risk and any changes in those methods compared to the previous period. We believe disclosures that provide a detailed explanation of such changes and quantitative disclosure of the amounts involved can help to enable users to assess the impact of such changes.

Level 2 financial instrument measures

4.16 There is scope for considerable differences in the risk profile of financial instruments classified as level 2 in the fair value hierarchy mandated by IFRS 7. For example, at one extreme a level 2 instrument may be a highly liquid instrument with a widely accepted valuation methodology. However, at the other extreme, it may be priced in a way that involves flexing observable data (and consequently requires more judgement as to whether the instrument falls under level 2 or 3). In the latter case it becomes particularly important how management views the inputs. For example, certain inputs, such as credit factors, may be viewed by management as insignificant but observable, or as current rather than outdated.

4.17 Although extensive disclosure is required for level 3 instruments, level 2 instruments require relatively little. In our view, bearing in mind the scope for considerable differences in level 2 instruments' risk profiles, it may often be useful to disclose where such judgements have been made about the nature of inputs, including reference to the types of instruments to which they apply.

Accounting judgements relating to market conditions

4.18 As a result of the current market conditions, we are seeing a number of debt buy-backs resulting in the recognition of one-off gains and losses and other balance sheet management exercises. Depending on the accounting judgements applied in such cases, there can be other, material impacts on the numbers reported. For example, reassessing the average life of the mortgage book can have an income statement effect. Accounting for loan portfolios purchased at a discount involves judging whether the Effective Interest Rate (EIR) should be recalculated, which will also have an income statement effect. These effects can be significant and, in such circumstances, it may be helpful to disclose the actions taken, the accounting judgements taken as a result, and the accounting effect involved.

Complex fair values and complex products

4.19 In August 2010 we issued DP10/4 *The prudential regime for trading activities: A fundamental review*. We made some comments in that paper about the disclosure of valuation methodologies and the disclosure of risks arising from complex products in the context of prudential regulation and intend now to consider the implications of those comments for the financial statements of CIs.

Risks arising from off-balance sheet arrangements

4.20 One of the concerns that was raised in the immediate aftermath of the financial crisis related to whether the risk exposures and potential losses associated with off-balance sheet entities and other arrangements were clearly identified and presented in financial disclosures. We think it is very important that users of financial statements are not taken by surprise about the extent to which a CI is, or could be, exposed to losses by such arrangements, and the circumstances in which those losses might crystallise. We are considering whether further improvements to the disclosures currently provided would be useful.

List of non-confidential respondents

Association for Financial Markets in Europe

BDO LLP

British Bankers' Association

Building Societies Association

Deloitte LLP

HSBC Holdings plc

Investment Management Association

KPMG LLP

PricewaterhouseCoopers LLP

Schroder Investment Management Limited

Standard Chartered Bank

The Institute of Chartered Accountants in England and Wales

The Institute of Chartered Accountants of Scotland

Final BBA Code for Financial Reporting Disclosure

BBA Code for Financial Reporting Disclosure

Background

The UK's seven largest lending institutions[1] (together the 'UK banks') recognise that there is a level of public interest in their disclosure that extends to other stakeholders in addition to investors. UK banks have gone beyond what is required by International Financial Reporting Standards (IFRS) as adopted in the European Union, statutory and regulatory requirements and the FSA's Listing, Disclosure and Transparency Rules to strive towards ensuring that the information they provide is commensurate with this interest.

Although the Directors of each UK bank remain responsible for ensuring that appropriate disclosures are provided for their entities, in order to further develop and enhance this commitment, the UK banks have:

- established a regular dialogue on financial statement disclosures as part of their preparatory work for producing annual and interim reports, with the aim of enhancing comparability and understanding. The details of this approach are set out in Annex 1; and plan to
- adopt this Code in respect of their financial reporting and include a statement of compliance with the Code in their annual reports.

This Code applies to disclosures in annual reports and accounts and interim reports.

The Code's principles are set out below in bold numbered paragraphs, with explanatory paragraphs where appropriate.

Overarching principle

1 **UK banks are committed to providing high quality, meaningful and decision-useful disclosures to users to help them understand the financial position, performance and changes in the financial position of their businesses.**

---

1 The groups headed by Barclays plc, HSBC Holdings plc, Lloyds Banking Group plc, Nationwide Building Society, Santander UK plc, Standard Chartered PLC and The Royal Bank of Scotland Group plc.

- Business strategy and business models should be described so that stakeholders can understand opportunities and risks.
- The Business Review should clearly "tell the story" of the business performance for the period under review and the key risk exposures should reflect information provided to the Board.
- Where relevant, quantitative disclosures should be accompanied by suitable qualitative narrative explaining the significance of the quantitative disclosures.
- Disclosures should be presented such that, to the extent practical, all information about a particular activity is provided in one place in the annual or interim report; where this is not possible, for example, to meet disclosure requirements of different jurisdictions, in as few places as possible and with clear cross references to allow easy navigation.
- Where disclosures are made (e.g. Key Performance Indicators in the Business Review) that show analyses that are not directly reconcilable to the financial statements, the context of the information and how it relates to the financial statements should be clearly explained.
- Where disclosures are made that show an analysis of assets or liabilities which are comprised of balances (or parts of balances) from different balance sheet line items, the disclosures should include reconciliation back to the relevant balance sheet line items.
- Disclosures should be reviewed at each reporting date to identify those that have become redundant or less relevant. These should be reduced or removed so that disclosures overall remain targeted and relevant.
- Boilerplate disclosures that do not convey meaningful, entity-specific information should be avoided.
- Disclosures should be made at an appropriate level of granularity to aid understanding of the information or activity being explained. Judgements about the level of detail should balance the necessary need for aggregation to avoid information overload against the need for granularity to enhance understanding and increase transparency and should be based on information provided internally to key management personnel. Significant balances should not be left unexplained.

Compliance with IFRS

2 **UK banks will continue to keep under review and are committed to ongoing re-evaluation and enhancement of their financial instrument disclosures for key areas of interest.**

To ensure that their financial statements continue to be of high quality, UK banks will continue to seek to identify those areas of their activities which are of particular interest to market participants. In making this assessment institutions will consider internal management information provided to the Board, relevant guidance and directions provided by UK, European and international regulators and standard setters as well as representations made by stakeholder groups.

UK banks acknowledge that high quality disclosures in the following areas are particularly important:

- Judgements in applying accounting policies (IAS 1.122).
- Informative explanations about accounting policies adopted (IAS 1.117).
- Key assumptions when estimating the carrying value of assets and liabilities (IAS 1.125).
- Information about financial risks and exposures and how they are managed (IFRS 7.31 to 7.35).
- Sensitivity analyses (IFRS 7.40).
- Methods and assumptions supporting fair value estimates (IFRS 7.27).
- Nature and extent of risks arising from financial instruments (IFRS 7.31).
- Information about credit quality of assets (IFRS 7.36 to 38).
- Significant changes to carrying values at interim reporting periods (IAS 34.15).

IASB Expert Advisory Panel, Senior Supervisors Group and other good practice guidance

3 **UK banks acknowledge the importance of good practice recommendations and similar guidance issued from time to time by relevant regulators and standard setters and will assess the applicability and relevance of such guidance to their disclosures.**

As necessary, UK banks will continue to consider going beyond what is required by IFRS, statutory and regulatory requirements and listing rules to ensure that the information they provide to stakeholders meets these objectives.

Accordingly UK banks will assess, and reflect to the extent relevant to their business models and mixes, good practice recommendations made by the IASB's Expert Advisory Panel, the Financial Stability Board, Senior Supervisors' Group and Committee of European Banking Supervisors and other guidance of similar standing.

UK banks will also keep under review topical and emerging issues. Even though topical issues may not be material in relation to their overall business, it may be material for the sector or otherwise important to the business and as such relevant for stakeholders. The UK banks will consider providing information to enable stakeholders to understand the effect on the bank's business of these issues.

In considering what matters would be regarded as a topical or emerging issue, the UK banks will consider a number of factors such as: market conditions, information provided to the Board, feedback and guidance from regulators, standard setters, and stakeholder groups.

Depending on the nature of the topical or emerging issue, the following types of disclosure may be appropriate:

- Balance sheet and income statement amounts for the activity.
- Explanation of the business strategy.
- Explanation of opportunities and risks and the potential for any significant income statement charge.

It may also be relevant to confirm that the bank does not have exposure to a particular risk.

4 **UK banks will seek to enhance the ability to compare financial statement disclosures across the UK banking sector.**

In adopting new standards, best practice recommendations and considering key market areas of interest which require enhanced disclosures, UK banks will implement, where appropriate, consistent approaches to aid comparison and understanding.

While each bank's business model and financial exposure is different, it is recognised that users seek to undertake comparisons between banks.

To assist users with this and their understanding of financial reports, the UK banks:

- recognise that disclosures in tabular form are a good way to facilitate understanding and enhance the ability to compare across institutions.
- will continue to converge their definitions of non-IFRS terms. In this context, 'convergence' does not necessarily mean identical definition; rather, a level of equivalence in definition to enhance the ability of stakeholders to make (a) an assessment of each individual UK bank's assets and liabilities, financial position, performance and risk profile; and (b) meaningful comparisons across the UK banking industry.

To assist users with this and their understanding of financial reports, the UK banks will provide within their annual reports a glossary of terms. The glossary will set out the definitions of key non-IFRS terms used in relation to financial instruments as well as other important terms and acronyms used in their reports. These definitions should be of sufficient detail to enable the scope of disclosures to be differentiated where appropriate.

5 **UK banks should clearly differentiate in their annual reports between information that is audited and information that is unaudited.**

UK banks acknowledge that it is important that there is a clear differentiation between audited and unaudited information. They will therefore ensure that audited information reported outside of their financial statements is clearly and specifically noted, particularly where audited and unaudited information is included on the same page.

British Bankers' Association
10 September 2010

Annex 1 – The UK banks' agreed approach for an ongoing process to meet and discuss financial statement disclosures

UK banks have a history of working together through the BBA's Financial Reporting Advisory Panel to understand and prepare for the adoption of new financial reporting requirements. In the past, specific Working Parties have been established to prepare for such major events as the first time adoption of IFRS, the application of IFRS 7 and the implementation of Pillar 3 of the Basel II Accord.

To ensure that their financial statements continue to provide users with meaningful and decision-useful information about changes in their financial position and performance, UK banks will build on this past work and commit to meet before key reporting periods to:

- discuss the application of new IFRS disclosure standards and, where necessary, approaches to enhance the consistency of application of these disclosures in terms of interpretation, definition and presentation;
- consider best practice guidance produced by relevant regulators including interpretation, definition and presentation;
- identify topical issues which are material to the market as a whole and may require additional disclosure; and
- review the comparability and consistency of disclosures generally.

In addition, UK banks have agreed to meet with the Financial Services Authority, as part of their reporting preparations in advance of each interim and annual reporting period, to discuss areas of interest relevant to disclosures for that reporting period.

The Directors of each UK bank remain responsible for ensuring that appropriate disclosures are provided for their entities.

The group will not discuss in any way current pricing/cost levels or trends nor any specific customer related information or any issue considered commercially sensitive.

PUB REF: 002327

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: http://www.fsa.gov.uk