RECOMMENDATIONS FOR

PUBLIC DISCLOSURE OF TRADING AND DERIVATIVES ACTIVITIES

OF BANKS AND SECURITIES FIRMS

Consultative paper issued jointly by the
Basle Committee on Banking Supervision
and the
Technical Committee of the International Organization of Securities Commissions (IOSCO)

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of the Basle Committee on Banking Supervision

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EXECUTIVE SUMMARY

Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms

This paper, issued jointly by the Basle Committee on Banking Supervision and the IOSCO Technical Committee, presents recommendations for public disclosures of trading and derivatives activities of banks and securities firms. These recommendations complement their annual survey of trading and derivatives disclosures of large, internationally-active banks and securities firms, last published in November 1998. Both initiatives form part of a continued effort by the two Committees to encourage banks and securities firms to provide market participants with sufficient information to understand the risks inherent in their trading and derivatives activities.

The two Committees consider transparency of banks' and securities firms' activities and risks to be a key element of an effectively supervised financial system. Meaningful and accurate information reported in a timely manner provides an important foundation for the decisions of market participants. Well-informed investors, depositors, customers and creditors can impose strong market discipline on an institution to manage its activities and risk exposures in a manner that is both prudent and consistent with its stated business objectives.

The recommendations in this paper follow two main themes.

- First, institutions should provide financial statement users with a clear picture of their trading and derivatives activities. They should disclose meaningful summary information, both qualitative and quantitative, on the scope and nature of their trading and derivatives activities and illustrate how these activities contribute to their earnings profile. They should also disclose information on the major risks associated with their trading and derivatives activities and their performance in managing these risks.

- Second, institutions should disclose information produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing these exposures. Linking public disclosure to internal risk management processes helps ensure that disclosure keeps pace with innovations in risk measurement and management techniques.

The Basle Committee and the IOSCO Technical Committee recommend banks and securities firms implement the guidance on quantitative and qualitative disclosures presented in this paper. In addition, banks and securities firms should consider disclosure initiatives by other national and international bodies and the types of disclosures provided by their peers at the international level.

The disclosure recommendations may also be useful to other financial and non-financial companies with significant trading and derivatives activities. Accounting standard-setters, regulators and other bodies responsible for setting disclosure standards may also find the document helpful as they continue working on developing improved and more harmonised public disclosure standards. This paper does not intend to replace or override other reporting frameworks that may be more extensive.

The recommendations presented in this paper supersede the recommendations issued by the two Committees in 1995 in connection with their first survey report on the trading and derivatives disclosures of banks and securities firms. Since then, various developments have taken place, such as the increase in financial institutions' use of derivatives, changes in the use and design of risk management techniques, and the continued evolution and improvement of disclosure standards and practices.

Invitation to comment

This paper is being released for consultation. The two Committees invite comments from all interested parties, including supervisory and regulatory bodies, banks, securities firms, industry groups, and accounting standard-setters. The comments, which will be considered in the finalisation of the guidance, must be received no later than ***31st May 1999***. The two Committees intend to release a final version of the paper in the second half of 1999.

Comments should be sent to:

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RECOMMENDATIONS FOR PUBLIC DISCLOSURE OF TRADING AND DERIVATIVES ACTIVITIES OF BANKS AND SECURITIES FIRMS

FEBRUARY 1999

I. General remarks

(1) Introduction

1. This paper, issued jointly by the Basle Committee on Banking Supervision[1] (Basle Committee) and the Technical Committee of the International Organization of Securities Commissions[2] (IOSCO Technical Committee), presents recommendations for public disclosures of trading and derivatives activities[3] of banks and securities firms. These recommendations complement their survey of trading and derivatives disclosures of banks and securities firms, which has been published annually since 1995.[4] Both initiatives form part of a continued effort by the two Committees to encourage banks and securities firms to provide market participants with sufficient information to understand the risks inherent in their trading and derivatives activities.

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1 The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Its current chairman is Mr. William J. McDonough, President of the Federal Reserve Bank of New York. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

2 The Technical Committee of IOSCO is a committee of the supervisory authorities for securities firms in major industrialised countries. It consists of senior representatives of the securities regulators from Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, Ontario, the Netherlands, Quebec, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Its current Chairman is Mr. Michel Prada, President of the Commission des Opérations de Bourse in France.

3 "Trading and derivatives" activities comprise trading activities (for both cash and derivative instruments) and non-trading derivatives activities.

4 These survey reports examine public disclosures in annual reports of banks and securities firms from 1993 to 1997. They were published in November 1995, November 1996, November 1997 and November 1998, respectively.

2. The Committees' efforts are consistent with, and reinforced by, public statements made by the G-7 Heads of State and Finance Ministers on the importance of transparency in promoting financial stability. These statements recognise that improved transparency of institutions' financial condition, performance, business activities, risk profile and risk management practices, facilitates effective market discipline and sound and efficient functioning of financial markets. Thus, transparency can reinforce supervisory efforts to promote safety and soundness in individual institutions and financial systems as a whole. This proposal would supplement reporting and disclosure requirements of a variety of national accounting and disclosure frameworks. This paper does not intend to replace or override other reporting frameworks that may be more extensive.

3. This paper was prepared in collaboration between the Transparency Group[5] of the Basle Committee and the IOSCO Working Party on the Regulation of Financial Intermediaries.[6] The recommendations presented in this paper supersede the recommendations issued by the two Committees in 1995.[7]

(2) Objective

4. The objective of this paper is to promote the transparency of the trading and derivatives activities of large banks and securities firms by providing guidance on appropriate disclosures. The disclosure recommendations may also be useful to other financial and non-

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5 The Basle Committee's Transparency Group is chaired by Ms. Susan Krause, Senior Deputy Comptroller for International Affairs at the US Office of the Comptroller of the Currency and a member of the Basle Committee. The group's mission is to enhance market discipline, promote stable and efficient markets, and improve effective and comprehensive supervision of banking institutions. The Transparency Group carries out this task by identifying issues and developing guidance on the information needed by supervisors and by market participants to assess risk. It consists of supervisory experts on disclosure and reporting from the member institutions of the Basle Committee.

6 The IOSCO Working Party on the Regulation of Financial Intermediaries was chaired until early February 1999 by Mr. Richard Britton of the UK Financial Services Authority (FSA) and then by Mr. Paul Wright, also of the FSA. The group has carried out a substantial programme of work in recent years, particularly in the areas of prudential supervision and client protection. It has the lead responsibility under the auspices of the Technical Committee for coordination and consultation with the work of the Basle Committee. It consists of securities regulators from the member institutions of the IOSCO Technical Committee.

7 When the Basle Committee and the IOSCO Technical Committee in November 1995 issued their first report on the public disclosure of trading and derivatives activities of banks and securities firms, it contained a series of recommendations for the further improvement of trading and derivatives disclosure of banks and securities firms. Since then, various developments have taken place, such as the increase in financial institutions' use of derivatives, changes in the use and design of risk management techniques, and the continued evolution of disclosure standards and practices.

financial companies with significant trading and derivatives activities. Accounting standard-setters, regulators and other bodies responsible for setting disclosure standards may also find the document helpful as they work on developing improved and more harmonised public disclosure standards.

5. The Basle Committee and the IOSCO Technical Committee believe that transparency, based on meaningful public disclosure, plays an important role in reinforcing the efforts of supervisors in encouraging sound risk management practices and fostering financial market stability.[8] Enhanced transparency should also benefit banks and securities firms themselves both by enhancing their ability to evaluate and manage their exposures to counterparties, and also by reducing the likelihood that they become susceptible to market rumours and misunderstandings during periods of financial stress.

(3) Contents of the report

6. After this introduction, Section II discusses the importance of enhancing the transparency of trading and derivatives activities. This section also references other recent disclosure initiatives by regulators, standard-setters and industry groups in this area.

7. Section III provides guidance to large banks and securities firms with significant involvement in trading and derivatives activities on appropriate disclosures with respect to such activities. The recommendations follow two main themes.[9]

- First, institutions should provide financial statement users with a clear picture of their trading and derivatives activities. They should disclose meaningful summary information, both qualitative and quantitative, on the scope and nature

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[8] The role of disclosure and transparency in fostering safe and sound banking systems is discussed in *Enhancing Bank Transparency* (the "Krause Report"), issued by the Basle Committee in September 1998. In addition to this proposal, the Basle Committee is currently developing further disclosure guidance in the areas of credit risk and capital adequacy.

[9] These recommendations draw on concepts developed in:

- the *Framework for Supervisory Information About the Derivatives and Trading Activities of Banks and Securities Firms* ("the Supervisory Information Framework"), issued by the Basle Committee and the IOSCO Technical Committee in September 1998,
- the Krause Report, and
- the *Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries* ("the Fisher Report"), released by the Euro-currency Standing Committee of the G-10 central banks in September 1994.

of their trading and derivatives activities and illustrate how these activities contribute to their earnings profile. They should also disclose information on the major risks associated with their trading and derivatives activities and their performance in managing these risks.

- Second, institutions should disclose information produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing these exposures. Linking public disclosure to internal risk management processes helps ensure that disclosure keeps pace with innovations in risk measurement and management techniques.

8. The Basle Committee and the IOSCO Technical Committee recommend banks and securities firms implement the recommendations for quantitative and qualitative disclosures presented in this paper. In addition, banks and securities firms should consider disclosure initiatives by other national and international bodies such as accounting standard-setters and regulators, including those referred to in Section II. Further, they should consider the types of disclosures provided by their peers at the international level, as outlined in the survey of trading and derivatives disclosures issued by the two Committees in November 1998.[10]

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[10] *Trading and derivatives disclosures of banks and securities firms - Results of the survey of 1997 disclosures*, Basle Committee and IOSCO Technical Committee, November 1998.

II. Enhancing the transparency of trading and derivatives activities

(1) The importance of achieving transparency of trading and derivatives activities

9. As discussed in the Krause Report, market discipline can reinforce the objectives of supervision by rewarding institutions that manage risks effectively and penalising those whose risk management is weak or ineffective. Meaningful and accurate information reported in a timely manner provides an important foundation for the decisions of market participants. Well-informed investors, depositors, customers, creditors and other counterparties can impose strong market discipline on an institution to manage its activities and risk exposures in a manner that is both prudent and consistent with its stated business objectives.

10. While trading and derivatives activities generally involve types of risks that are similar to those associated with more traditional activities of banks and securities firms, the management of financial risks in trading and derivatives activities is a highly dynamic process, where the potential for large gains and losses in a short period of time is well demonstrated. Timely and reliable information on these activities is essential to accurate assessments of an institution's condition, performance and risk profile, yet the level of transparency surrounding trading and derivatives activities has often been considered unsatisfactory by users of information and not commensurate with the growth and complexity of these activities.[11]

11. To strengthen market participants' ability to encourage safe and sound practices in banks and securities firms, it is important that public disclosure provides comprehensive information about how an institution's trading and derivatives activities contribute to its overall risk profile and profitability and how well it manages the risks arising from these activities. Information should be provided with sufficient frequency and timeliness to give a meaningful picture of the institution's financial position and prospects. In the case of trading and derivatives activities, it is of particular importance that disclosures are timely and forward-looking since banks and securities firms rapidly can change their position and risk profile. If trading and derivatives positions or strategies change during the financial reporting period, it may be inappropriate to delay disclosing this information until the next annual or

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[11] The annual surveys on trading and derivatives disclosures conducted by the two Committees indicate that, while there have been improvements, there are still some institutions that disclose little about their trading and derivatives activities.

interim report. Indeed, stock exchange listing requirements typically require listed companies to immediately announce any new, price sensitive information to the market.

12. Information should also be comparable. Market participants and other users need information that can be compared across institutions and countries, and over time. Comparability in information across banks and across countries enables users to assess the relative financial position and performance of institutions against other institutions. Comparability over time is necessary for the identification of trends.

13. Disclosures should be adapted to the size and nature of an institution's trading and derivatives activities in accordance with the concept of materiality.[12] For example, some institutions are wholesale market makers in a range of cash and derivative instruments, while others primarily use derivatives for their own risk management purposes. The extent of information disclosed about trading and derivatives activities should relate the importance of these activities to the institution's overall business, earnings and risk profile.

14. Banks and securities firms themselves should be interested in providing meaningful disclosures of their trading and derivatives activities. An institution that provides little information about its risk profile may be susceptible to market rumours and misunderstandings by market participants in times of stress, which could possibly result in loss of business with counterparties, a higher cost of capital, and funding difficulties. Moreover, such disclosures can provide institutions with a clearer picture of the risk profile of their counterparties, enabling them to better manage risks and to arrive at more informed business decisions.

15. It is important that the disclosure practices of banks and securities firms reflect and keep pace with the growth and innovation of their trading and derivatives activities and the internal systems used to manage these activities. Ideally, public disclosures should be consistent with approaches that institutions use internally to measure and manage risk, thus capturing enhancements in risk management practices over time. Drawing on information already produced internally for risk management purposes should also reduce costs and the burden of enhanced public disclosures.

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[12] Information that is not disclosed because it is immaterial may, nevertheless, be relevant for internal risk management purposes and in supervisory assessments. Information of this nature should be available within regulated firms and their material affiliates, and should be accessible to supervisors.

16. Transparency of trading and derivatives activities is a key element of an effectively supervised financial system. Strong internal risk management and controls by banks and securities firms, reinforced through prudential supervision and enhanced public disclosure practices provide a framework for fostering a stable financial system in an environment of rapid financial innovation and increasing complexity.

(2) Other disclosure initiatives

17. In addition to the Basle Committee and the IOSCO Technical Committee, several other national and international bodies have issued standards, proposals or rules relating to trading and derivatives disclosures. Many of these initiatives have affected current disclosure practices or are likely to influence future practices. Where these disclosure initiatives go beyond mandatory local requirements, institutions are encouraged to consider them in order to improve the comparability and quality of their trading and derivatives disclosures.

- *International Accounting Standard IAS 32 "Financial Instruments: Disclosure and Presentation"*. IAS 32 was issued by the International Accounting Standards Committee (IASC) in June 1995, and includes requirements for disclosure of terms, conditions and accounting policies for financial instruments, interest rate risk and credit risk data, and the fair value of on- and off-balance-sheet financial instruments. In December 1998, the IASC Board adopted *IAS 39 "Financial Instruments: Recognition and Measurement."* The standard introduces disclosure requirements for financial risk management objectives and policies.

- *The Handbook of the Canadian Institute of Chartered Accountants Section 3860, Financial Instruments – Disclosure and Presentation.* This Section prescribes requirements for presentation of financial instruments and identifies the information that should be disclosed. The disclosure recommendations deal with information about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments. In addition, this Section encourages disclosure of information about the nature and extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them and management's policies for controlling those risks. The Section applies to all entities beginning on or after 1 January 1996 (with some exceptions). In October 1995, the Office of the Superintendent of Financial Institutions (OSFI) issued guideline D-6 – Derivative Disclosure. This guideline provides federally regulated financial institutions with application guidance to Section 3860 and outlines additional disclosure requirements.

- *French guidance on market risk disclosures.* In 1998, the National Accounting Council (CNC)[13] issued two documents on market risk disclosures. *Advice n°98.05* contains best practice guidance regarding disclosure of information on market risk items in the notes to the accounts. This document requires banks and investment firms supervised by the Banking Commission to disclose information on accounting principles and rules, profitability of banking activities, counterparty risk in derivatives activities, and off-balance sheet items (especially derivatives). *Recommendation n°98.R.01* requires information relating to business strategies (to be provided by sector and geographic breakdown), interest rate risk and foreign exchange risk, as well as qualitative and quantitative information relating to market risk exposures.

- *The Japanese Ministry of Finance's new regulations about market value accounting for trading activities.* Since 1 April 1997, Japanese banks and securities firms may adopt mark-to-market accounting for their trading activities (including derivatives), provided they meet certain approval standards on internal control, valuation and accounting procedures set by the Ministry. This change improves the information available to the public about banks' and securities firms' periodic performance in their trading and derivatives activities.[14]

  Furthermore, in July 1996, Japanese ministerial ordinances and circulars (e.g. Regulation concerning Terminology, Forms and Method of Preparation of Financial Statements, etc.) were revised to enhance derivatives disclosure of all firms. The revisions are effective from the period that ended in March 1997 and require firms to disclose qualitative information as well as notional amount information for all derivatives, including over-the-counter instruments. The revisions also include a recommendation for the disclosure of quantitative information on market risk and credit risk. Moreover, as from the period ending in March 1998, disclosure of market value information for over-the-counter instruments is required.

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13 While the National Accounting Council (Conseil National de la Comptabilité, CNC) is responsible for defining best accounting practice in France, the Accounting Regulations Committee (Comité de la Réglementation Comptable, CRC) is the national accounting standard-setter with power to put the guidance adopted by the CNC into mandatory regulations.

14 It should be noted that mark-to-market or fair value accounting for trading activities is already accepted practice for all or part of the trading book in many other countries.

- *Swiss Bankers' Association's "Guidelines Concerning Risk Management in Trading and Use of Derivatives."* This paper, issued in 1996, indicates that banks should provide appropriate qualitative and quantitative information (value-at-risk, confidence interval, credit risk, gross and net positive replacement values, add-on, breakdown according to the quality of counterparts, etc.) and recommends the use of international standards.

- *The UK Accounting Standards Board's (ASB) Financial Reporting Standard (FRS) 13 "Derivatives and Other Financial Instruments: Disclosure".* FRS13, which was issued in September 1998, requires UK entities to provide a comprehensive range of information about the risks arising from their financial instruments and their attitude and response to those risks. The FRS comes into force for periods ending on or after 23 March 1999 and applies to listed companies other than insurance undertakings and to all banks. The main disclosures will be interest rate risk disclosures, currency disclosures and liquidity and maturity disclosures, information on fair values and the effects of hedge accounting.

- *The US Securities and Exchange Commission (SEC) "Market Risk" disclosure rule.* This rule was proposed in 1995 and was finalised by the SEC in January 1997. The rule affects virtually all public companies in the US for fiscal years ending after 15 June 1998. In addition to requiring specific quantitative and qualitative disclosures about market risk, it requires specific disclosures about an institution's accounting policies relating to derivatives and reasons for material quantitative changes in market risk exposures between current and previous years. Companies can use one or more of three alternatives in disclosing quantitative information about market risk:

    - A table of contract terms and other information, including fair value of market risk sensitive instruments, expected cash flows for each of the next five years and in the aggregate thereafter, effective rates or prices;

    - A sensitivity analysis of a hypothetical loss in earnings, fair values, or cash flows due to a reasonably possible near term change from current interest rates, foreign exchange rates, commodity prices, and other market rate or price changes;

    - Value-at-risk disclosures for derivative and financial instruments expressing the potential loss in fair values, earnings, or cash flows of

market risk sensitive instruments that might arise from market movements of a given likelihood of occurrence over a time interval.

- *The US Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133* entitled *Accounting for Derivative Instruments and Hedging Activities*. This statement, effective 15 June 1999, establishes accounting and disclosure standards for derivative instruments and for hedging activities. In summary, it requires that an entity recognise all derivatives as either assets or liabilities and measure them at fair value. The entity must disclose its objectives for holding or issuing derivatives and indicate the entity's risk management policies, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description should indicate the purpose of the derivatives. The Statement specifies the accounting treatment based on the designated use of the derivative and requires disclosure of the resulting earnings effects.

- *The amended Basle Capital Accord for market risk capital rules and the EU capital adequacy directive.* The disclosure of information about the regulatory capital charges for market risks and their calculation became common in many countries in 1996. The amended Basle Capital Accord requires market risk capital rules to be implemented for internationally active banks in the G-10 countries as of January 1998. According to European Union law, market risk capital rules were to be effective by year-end 1995 for banks and securities firms in EU member states.

- *Forthcoming European Commission recommendation on disclosure of information on financial instruments.* In line with the European Commission's commitment to keep pace with developments in the accounting field at the international level, the Commission will bring forward a recommendation later in 1999 on the disclosure by banks and other financial institutions of information on financial instruments in their annual accounts.

III. Recommendations

18. The Basle Committee and the IOSCO Technical Committee encourage banks and securities firms to provide meaningful summary information, both qualitative and quantitative, about their trading (for both derivative and cash instruments) and non-trading derivatives activities.[15] Disclosures should provide a clear picture of the scope and nature of an institution's trading and derivatives activities and illustrate how these activities contribute to an institution's earnings profile. Institutions should disclose information on the major risks associated with their trading and derivatives activities, including credit risk, market risk, liquidity risk, operational risk, legal risk, and reputational risk. In addition, institutions should disclose information on their performance in managing these risks, particularly with regard to exposure to market and credit risks. To enable the user of financial statements to have the appropriate context to understand the information, disclosures should be separated for trading and non-trading activities.

19. As originally discussed in the Fisher Report and, more recently the Krause Report, institutions should disclose both qualitative and quantitative information on their risk exposures and on their performance in managing these exposures. Ideally, the disclosures should be made in a manner that is consistent with the methodologies employed in their internal risk measurement and performance assessment systems. Linking public disclosure to internal risk management practices may help ensure that disclosure keeps pace with innovations in risk management practices over time, particularly in areas undergoing rapid evolution such as market and credit risks.

20. Disclosures should focus on an institution's material risk exposures and the amount of information provided should be proportional to the importance of the activity to the institution's overall business, risk profile, and earnings. To provide an appropriate perspective on changes in an institution's risk profile, an analysis of trends in the level of derivatives and trading activities and the risks associated with those activities (e.g., year-to-year trend in the level of market risk and credit risk) should also be provided.

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[15] Throughout this paper the term "non-trading" is used to describe derivatives that are used by management for risk management purposes such as hedging and asset/liability management.

(1) Qualitative disclosures

21. Qualitative disclosures provide management with an opportunity to elaborate on and provide depth to the quantitative disclosures provided in the annual report. Users of financial statements need qualitative information to have the appropriate perspective necessary to understand the numbers reported in financial statements and schedules. In all cases, qualitative disclosures should be consistent with the quantitative information included in the financial statements.

22. Since quantitative disclosures, even if frequent, typically provide only a point in time picture of an institution's activities, it is important that an institution provides qualitative information on business objectives, strategies and risk-taking philosophy. Management should use the qualitative discussion to explain how trading and derivatives activities fit into the institution's business objectives, their strategies for achieving those objectives (addressing all on- and off-balance-sheet components), their risk-taking philosophy, and how these activities affect the overall level of risk undertaken by the institution. Such discussion should include the necessary context to understand the objectives. Further, management should discuss their policies for using derivatives and describe the principal internal control procedures that are in place for managing trading and derivative activities. In addition, such disclosures should include a summary of activity in new and innovative, complex, or leveraged instruments, and the risks associated with these activities.[16]

23. At a minimum, management should address whether derivatives are used primarily for trading or non-trading purposes and whether the institution primarily uses exchange-traded or OTC derivatives[17]. For trading activities, general disclosures should indicate whether, in the view of management, the institution is a wholesale market maker, engages in proprietary trading, or takes positions as an accommodation to customers. In addition, to alert the financial statement user to potential changes in risk levels, management should discuss any material changes in the trading strategies, risk tolerances, and risk management systems discussed in previous financial statements.

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[16] The concept of materiality applies to the disclosure recommendations made throughout this paper, but are particularly applicable here.

[17] Exchange-traded and over-the-counter derivatives have fundamentally different characteristics that affect their relative risk. Specifically, OTC derivatives have greater credit risk and liquidity risk than exchange-traded derivatives. As discussed below, institutions should also disclose information on the effect of credit enhancements on their counterparty credit exposure from OTC contracts, e.g., netting agreements and clearing arrangements.

24. In addition, institutions should describe their objectives for their non-trading derivatives activities and their strategies for achieving those objectives. For example, in the case of banks, such disclosures should describe how derivatives are used to hedge foreign exchange risk, interest rate risk, or other risk inherent in banking activities. The disclosures should distinguish between different types of hedge strategies employed, address the risk management policy for each type of hedge, and include a description of the items or transactions for which risks are hedged. Such information should be placed in the context of related on-balance sheet positions.

25. Specifically, banks and securities firms are encouraged to consider the following types of summary qualitative information about their trading and derivatives activities:

(a) Risks and management controls[18]

26. Institutions should provide an overview of key aspects of the organisational structure central to the institution's risk management and control process for its trading and derivatives activities (e.g., structure of risk control functions/committees). Each of the major risks arising from an institution's trading and derivatives activities, including credit, market, liquidity, operational, legal, and reputational risk should be described. The description should address how those risks arise, and the methods used to measure and manage the risks. For example, an institution should discuss its limit policies for exposures to market and credit risks and explain how value-at-risk measures are used to manage market risk and, where relevant, credit risk. In addition, the institution should describe its method for assessing its performance in managing these risks.

(b) Market risk

27. Institutions should summarise their policies for measuring and managing market risk and discuss how performance in managing market risk is assessed. For example, discussions of the structure of the independent market risk management/control units, internal controls, risk limits (e.g., value-at-risk limits), and limit monitoring processes will help a user understand the nature of the control environment.

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[18] See the Basle Committee paper *Framework for Internal Control Systems in Banking Organisations*, September, 1998, and the IOSCO Technical Committee report *Risk Management and Control Guidance for Securities Firms and Their Supervisors*, May 1998, for additional information on management controls.

28. Quantitative disclosures on market risk should be supplemented with information on the major assumptions and parameters used by internal models to facilitate an understanding of an institution's market risk disclosures. For example, in the case of value-at-risk disclosures, institutions should specify the type of model used (variance/covariance, historical simulation, etc.), the portfolios covered by the model, and information on the model's parameters such as the holding period, confidence level and the observation period. An institution should also disclose its method of aggregating risk and whether its model recognises correlations within markets (e.g., currencies) and between market factors (e.g. interest rate and currency instruments). Further, institutions should discuss their process for validating and back testing internal models.

29. Qualitative market risk disclosures should also discuss the institution's process for stress testing portfolios under adverse market conditions. Such information may include the types of portfolios stress tested, the process by which stress test scenarios are developed, the frequency of stress testing, and management's response to stress testing results.

30. Disclosures should also discuss material changes in market risk exposures and risk management strategies since the previous reporting period that may not be apparent from reviewing quantitative information in isolation. Such disclosures may provide a forward looking perspective of the institution's risk profile.

(c) Credit risk

31. Institutions should summarise their policies for identifying, measuring and managing credit risk. For example, such a discussion might address the structure of the credit risk control/loan review function, internal controls, risk limits (e.g. counterparty, pre-settlement, settlement, and concentration limits) and limit monitoring. If an institution stress tests its counterparty credit exposures, the process for stress testing should be discussed.

32. Qualitative disclosures for credit risk should also address an institution's mechanisms to reduce credit exposure, including their use of collateral, margin, bilateral or multilateral netting agreements, and early termination agreements. Institutions should also discuss how performance in managing credit risk is assessed.

33. With respect to OTC derivative contracts and other debt instruments, an institution should provide information about its methodologies for measuring and managing credit risk. Many institutions have developed sophisticated internal models to calculate potential credit exposure, which reflects possible changes in replacement costs. If the institution uses an

internal model to measure potential credit exposure, key information such as the type of model and its major assumptions (e.g., confidence interval) should be disclosed.

34. Furthermore, through the use of statistical models some institutions calculate expected/unexpected credit losses which arise from the possibility that counterparties may default on their obligations. Similar to potential credit exposure, it would be useful to provide the model-related qualitative information (e.g., assumptions).[19]

(d) Liquidity risk

35. Institutions should describe how liquidity risk arises and how it is relevant to their trading and derivatives activities. In addition, institutions should discuss the practices it undertakes to manage liquidity risk and how liquidity risk is considered in determining the mark-to-market value of trading positions. Further, institutions should discuss how performance in managing liquidity risk is assessed.

(e) Other risks

36. Legal, operational, and reputational risks often pose significant concerns to institutions, but accurate measurement of these risks is often difficult. However, institutions can help financial statement users understand these risks by providing information on the nature of the risks and describing how they relate to the institution's activities. In addition, institutions should describe their methods for identifying and managing these risks in their trading and derivatives activities.

(f) Accounting and valuation methods

37. Institutions should describe the accounting policies and methods of income recognition that they use for trading activities (involving both cash instruments and derivatives) and non-trading derivatives activities. Disclosures about accounting policies should enable the user of financial statements to understand any important distinctions that exist in the accounting treatment of various types or uses of derivatives instruments. Because the accounting practices for derivatives are not always consistent across countries, or for that

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[19] The Basle Capital Accord does not permit institutions to incorporate the results of credit risk models in determining their capital adequacy (unlike market risk models). However, such models are becoming increasing popular as a means to efficiently manage credit risk.

matter, across institutions within a country, it is particularly important that an institution sufficiently describe the accounting treatment of its derivative instrument holdings.

38. For example, it would be useful to summarise the methods used to account for derivatives, the types of derivatives accounted for under each method, and the criteria to be met for each accounting method used (e.g. criteria for recognising hedges). Furthermore, institutions should specify the accounting treatment for terminated hedges and hedges of anticipated transactions. They should also discuss the accounting treatment that is applied if specified hedge criteria are not met. In addition, institutions should discuss the policies and procedures followed for netting assets and liabilities arising from derivatives transactions.

39. Institutions should also discuss the methods used to determine the fair value of its traded and non-traded derivative instruments. If an institution uses valuation adjustments[20] against instruments or portfolios, it should discuss the nature and justification for such reserves. In the case of instrument categories for which there are no quoted market prices, institutions should discuss the methods and assumptions used to estimate market value. Institutions should also include a description of their policies for determining and reporting non-performing derivatives contracts and for recognising credit losses in their disclosures.

40. Consistent with the objective of ensuring financial statements are comparable from period to period, any significant change in accounting policies for derivative contracts should be discussed. In addition, if an institution plans to adopt a new accounting rule in the future, (e.g., in response to a new regulatory requirement) it should disclose the new rule and the potential impact it may have on the financial statements.

(2) Quantitative disclosures

41. Institutions should provide financial statement users with a clear picture of their trading and derivatives activities through disclosure of quantitative information. Quantitative disclosures should include summary information about the composition of trading portfolios (trading assets should be distinguished from trading liabilities) and the use of derivatives for non-trading activities. Such information could include the end-of-period and average[21]

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[20] In some countries, accounting practice permits institutions to recognise valuation adjustments through income deferrals and allowance accounts. The most common types of such adjustments are for future credit losses and administrative costs. Institutions may also make adjustments for hedging costs, close-out costs, mark-to-model discrepancies, etc.

[21] Average value should be calculated using daily figures; if the institution does not calculate the figures on a daily basis, the most frequent interval than an institution generates should be used.

notional and market values of major categories of cash and derivative instruments held for trading and non-trading purposes. Further, as exchange traded and OTC derivatives have different inherent risks, institutions should separately provide this information for exchange-traded and OTC derivatives.

42. Information on market activity should be provided by broad risk category (interest rate, exchange rate, precious metals, other commodities and equities), by broad instrument category (futures, forwards, swaps and options) and by repricing date (maturity bands of one year or less, over one year to five years, over five years to ten years, over ten years to twenty years, and over twenty years).

(a) Market risk

43. Institutions should provide summary quantitative information on their exposure to market risk based on the methods they use for internal risk measurement purposes, together with information on their actual performance in managing these risks.

44. Because end-of-period value-at-risk figures provide only a point-in-time view of risk, institutions should disclose a range of values over the reporting period to provide a more dynamic representation of an institution's risk profile. Dealer banks and securities firms typically produce daily information on profits and losses on their trading activities for internal risk management purposes combined with daily value at risk numbers. Institutions are encouraged to draw from this internally generated information for public disclosure purposes to provide useful summary information that provides a clear picture of their market risk exposure and their effectiveness at managing this exposure (e.g., a histogram of daily profits and losses combined with daily value at risk numbers, and high, low, or average value-at-risk figures for the period). While daily information may be useful, summarising VAR figures and results on a weekly or monthly basis may provide a more appropriate summary of activity.

45. Other quantitative information that enhances the transparency of the institution's market risk profile includes the results of scenario analysis or impact of rate shocks and the number of times actual losses exceeded the value-at-risk estimate.

46. For non-traded portfolios, institutions should disclose the market and notional values of derivatives. In addition, information on value-at-risk or earnings-at-risk is useful for purposes of providing a comprehensive view of market risk. An institution might also consider disclosing information on the impact of rate shocks or scenario analysis on non-traded portfolios.

(b) Credit risk

47. Institutions should disclose both their gross current credit exposure (replacement cost) and potential future credit exposure to counterparties. Gross current exposure is the positive mark-to-market value of derivatives contracts and provides a point-in-time indication of risk. To account for the potential volatility of credit exposures over time, institutions should also disclose the future credit exposure that may result from changes in the market value underlying the derivatives contract. To provide further perspective on credit exposures, institutions should consider disclosing the average credit exposure or range of credit exposure over the reporting period. Institutions should also disclose information on credit exposure by maturity band.

48. Institutions should disclose information on the effect of credit enhancements on their counterparty credit exposure from OTC contracts if these enhancements materially reduce the level of credit risk. This information would include the effect of legally enforceable bilateral netting agreements on credit exposure. If the institution is a member of a multilateral clearing organisation for OTC contracts, the effect of multilateral netting should also be disclosed. If the institution uses collateral or guarantees to reduce counterparty credit exposure, the impact on credit exposures should be disclosed. Such disclosures should include the nominal and market value of the collateral provided.

49. The quality of credit exposure has a significant impact on ultimate credit losses, therefore, institutions should disclose information that provides a perspective on counterparty credit quality. For example, an institution should disclose counterparty credit quality by internal/external credit rating. Information on significant concentrations (e.g., by counterparty, industry, or geographic location) also provides meaningful information the quality of credit risk exposure. Other quantitative information disclosures may include replacement cost of non-performing contracts, credit losses incurred on derivatives instruments, and reserves established for credit losses.

50. With respect to potential credit exposure and expected/unexpected credit loss, outputs of internal models is increasingly important for an institution’s risk management and performance measurement process. Accordingly, many institutions have developed internal methodologies to calculate potential credit exposure more precisely than required by the add-ons approach of the Basle Capital Accord. It may be preferable to disclose such internal model based information, if an institution believes it is more accurate. Such disclosures may include credit losses predicted by the internal credit risk model compared with actual results.

51. For some institutions, credit derivatives have become a useful tool for managing credit risk. Credit derivatives allow an institution to transfer credit risk either as a protection buyer or seller. If an institution uses credit derivatives, it should disclose the notional amount of credit derivatives distinguished by protection sold/purchased and by type of instrument (e.g., total return swap, credit default swap, or other credit derivative). If these instruments would have a material affect on credit risk concentrations, an institution should also consider disclosing credit derivative exposure by reference asset.

(c) Liquidity risk

52. There are two types of liquidity risk to consider: market liquidity risk and funding liquidity risk. In terms of market liquidity risk, institutions should break out the notional amount and market value of exchange-traded and OTC contracts by market type (e.g., interest rate, foreign exchange contracts, commodity or equity contracts) and product (e.g., swaps, futures, forwards or options). Such data may provide insight into an institution's ability to offset exposures using other instruments.

53. Information on an institution's participation in exchange-traded and OTC contracts would also provide perspective on an institution's funding liquidity risk. Exchange-traded instruments require daily cash settlement that may have a significant impact on an institution's liquidity if they use these instruments to hedge OTC contracts. If the institution is a material collateral provider on OTC contracts, this information should also be disclosed.

54. To provide perspective on an institution's funding liquidity risk, it should disclose a gap schedule that illustrates the expected cash flows per period for both trading and non-trading derivatives.

(d) Other risks

55. As discussed previously, accurate measurement of legal, operational and reputational risks is often difficult. Institutions are encouraged to be innovative in identifying quantitative information that could be shared with financial statement users. One example of a quantitative legal risk disclosure that may be useful is to disclose the amount of current and potential loss exposures of contracts in dispute, if any.

(e) Earnings

56. Institutions are encouraged to disclose information on how trading activities affect earnings, as well as information on the earnings impact of non-trading derivatives activities.

As with market and credit risks, institutions should base such disclosures on their internal measurement and accounting systems if appropriate.

57. Institutions should provide a summary of trading revenues, for cash and derivatives instruments combined, broken down by major risk category (exchange, equities, commodities and other). Alternatively, institutions could provide a breakdown by major product (i.e. bonds, swaps, foreign exchange, equities, etc.). The approach chosen should be consistent with the institution's management of the activity.

58. An institution should also consider disclosing summary information on material trading gains and losses from broad trading strategies if such information would enhance a financial statement user's understanding of the firm's operating results. For example, if a particular strategy resulted in an unusually large gain or loss, it may be helpful to the financial statement user to understand that earnings results may be skewed by isolated, nonrecurring events.

59. For non-trading derivatives holdings[22], quantitative information about the effect on earnings of off-balance-sheet positions held by the organisation to manage interest rate risk, currency risk and other risks should be disclosed. This information provides insight into how derivatives are being used to manage non-trading risks (for example, exposure to interest rate risk) and the degree to which these efforts have been successful.

60. Accordingly, institutions should disclose the amount of cumulative deferred (realised and unrealised) losses from derivatives, the events that will result in recognition of these amounts in earnings, and the timing of their future recognition in the profit and loss account (e.g., within the next accounting period and beyond). In addition, such disclosures should identify the net gain or loss recognised in earnings from non-trading activities during the current reporting period and the category of income where it is recorded. If appropriate, this information may be broken out by hedging strategy, with the impact of hedge ineffectiveness segregated. Further, institutions should disclose the amount of deferred gain or loss that is recognised in current earnings because an institution changes its assumptions regarding whether a firm commitment or anticipated transaction will occur. It may also be useful to disclose the maximum period of time over which the institution is hedging and

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[22] Quantitative disclosures about derivative instruments may be more useful and less likely to be perceived to be out of context or misunderstood, if similar information is also disclosed about other financial instruments or non-financial assets and liabilities to which the derivative instrument is related.

deferring gain or loss on derivatives. Such information provides insight into how future earnings and capital may be affected by losses that have been incurred.

IV. Conclusion

61. To facilitate effective market discipline and sound and efficient functioning of financial markets, banks and securities firms should provide financial statement users with a clear picture of their trading and derivatives activities.

62. Institutions should provide meaningful summary information, both qualitative and quantitative, on the scope and nature of trading and derivatives activities and illustrate how these activities contribute to their earnings profile. They should disclose information on the major risks associated with their trading and derivatives activities, including credit risk, market risk, liquidity risk, operational risk, legal risk, and reputational risk. In addition, institutions should disclose information on their performance in managing these risks, particularly with regard to exposure to market and credit risks.

63. To help ensure that disclosure keeps pace with innovations in risk measurement and management techniques, institutions also should disclose information produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing these exposures.

64. The Basle Committee and the IOSCO Technical Committee encourage banks and securities firms to implement the recommendations presented in this paper and summarised in the attached Annex. The two Committees believe that transparency, based on meaningful public disclosure, can play an important role in reinforcing the efforts of supervisors in encouraging sound risk management practices and fostering financial market stability.

February 1999

Annex

Table of recommendations for trading and derivatives disclosures

Overview:
• Provide meaningful summary information, both qualitative and quantitative, about trading (for both derivatives and non-derivative instruments) and non-trading (risk management) derivatives activities
• Provide a clear picture of the scope and nature of trading and derivatives activities
• Provide meaningful summary information on how trading and derivatives activities contribute to an institution's earnings profile
• Provide information on the major risks (credit, market, liquidity, operational, legal and reputational risk) associated with these activities
• Disclose information on actual performance in managing these risks, particularly in regard to market and credit risks
• Provide separate disclosures for derivatives used for trading and derivatives used for non-trading purposes
• Disclose qualitative and quantitative information on risk exposures, and on performance in managing exposures in a manner that is consistent with the methods employed in their internal risk measurement and performance systems
• Focus disclosures on material risk exposures and ensure the amount of information disclosed stands in relation to the importance of the activity of the institution's overall business, risk profile, and earnings
• Provide trend information where useful (e.g., market risk and credit risk)
Qualitative disclosures – General
• Elaborate and provide depth on quantitative disclosures
• Discuss the overall business objectives of trading and derivatives activities and strategies for achieving those objectives
• Provide an overview of the institution's risk-taking philosophies and how trading and derivatives affect the overall level of risk

• Discuss the policies for using derivatives
• Discuss the principal internal control procedures for managing trading and derivative activities
• Provide summary information about activities involving material new/innovative, complex or leveraged derivative instruments (e.g. credit derivatives)and risks associated with these activities
• Discuss whether derivatives are used primarily for trading or non-trading purposes
• Discuss whether primarily involved in exchange traded or OTC derivatives
• Describe how institution uses trading (e.g., market maker, proprietary position, arbitrage, customer accommodations)
• Disclose material changes in trading/risk management strategies or risk tolerances and risk management systems
• Discuss the objectives for use of non-trading derivatives
• Describe how derivatives are used to hedge risks (strategies)
• Distinguish between different types of hedge strategies employed, the risk management policy for each type of hedge and a description of the items or transactions for which risks are hedged
• Where appropriate, place information on derivatives in the context of related on-balance sheet positions
Risk management – Qualitative disclosures
• Provide an overview of key aspects of the organisational structure central to the risk mgmt. and control process for trading and derivative activities (e.g., structure of risk control functions/committees)
• Provide a description of significant risks (e.g., market, credit , liquidity, legal, reputational, and operational) arising from trading and derivatives activities and how the risks arise
• Provide an explanation of how risks arise and the methods used to manage significant risks
• Discuss the methods used to assess performance in managing these risks
Market risk – Qualitative disclosures
• Discuss the methods used to measure and manage market risk

• Discuss how performance in managing market risks is assessed
• Describe the major assumptions and parameters used by internal models necessary to understand an institution's market risk disclosures
• Type of model used
• Portfolios covered by the model
• Holding period
• Confidence level
• Observation period
• Discuss the method of aggregating risk exposures
• Discuss the method used to recognise correlations between market factors (e.g. correlation assumptions)
• Provide an overview of policies and procedures for validating internal models
• Provide an overview of policies and procedures for back-testing internal models
• Provide an overview of policies and procedures for stress testing market risk
• Discuss changes in market risk exposure and risk management strategies from previous year
Credit risk – Qualitative disclosures
• Summarise policies for identifying, measuring and managing credit risk
• Discuss the structure of the credit risk control/loan review function, internal controls, risk limits and limit monitoring
• Discuss stress testing of credit risk, if applicable
• Discuss mechanisms to reduce credit exposure, including use of collateral, margin, bilateral or multilateral netting and early termination agreements
• Discuss how performance in managing credit risk is assessed
• If an internal model is used, provide information on the type of model and major assumptions used

• Portfolios covered by the model
• Confidence interval
• Holding period
• Observation period
Liquidity risk – Qualitative disclosures
• Describe how liquidity risk arises and is relevant to trading and derivatives activities
• Discuss the methods used to measure and manage liquidity risk
• Discuss how performance in managing liquidity risk is assessed
• Describe how liquidity risk is considered in determining market values
Other risks (operational, legal, reputational) – Qualitative disclosures
• Discuss the nature of other risks relevant to trading and derivatives activities and how they are managed
Accounting and valuation methods
• Discuss the accounting policies and methods of income recognition for trading and non-trading derivatives
• Describe the methods used to account for derivatives
• Describe the types of derivatives accounted for under each method
• Describe the criteria to be met for each accounting method used (e.g., hedge accounting criteria)
• Describe the accounting treatment for terminated derivative contract hedges
• Describe the accounting treatment for hedges of anticipated transactions
• Describe the accounting treatment if specified criteria are not met
• Describe the policies and procedures followed for netting assets and liabilities arising from derivative transactions

• Describe the methods used to determine the fair value of traded instruments and nontraded derivative instruments
• Where applicable, discuss the policies for determining adjustments and valuation reserves for trading and derivatives instruments (e.g., credit, operational liquidity and administrative reserves)
• Discuss the methods and assumptions used to estimate market value when quoted prices are not available
• Discuss the policies for determining and reporting non-performing derivatives contracts
• Discuss the accounting treatment for derivatives credit losses
• Discuss the significant changes in accounting policies for trading and derivative activities
• Discuss the anticipated changes in accounting policies for derivative contracts due to changes in regulatory reporting or accounting requirements and the potential impact on risk management strategies or financial statements
Quantitative disclosures – General
• Provide a clear picture of involvement in derivatives markets
• Provide summary information about composition of trading portfolios and the use of derivatives for non-trading activities
• Provide end-of-period and average notional amounts and market values for trading and non-trading portfolios
• Distinguish between trading assets and trading liabilities
• Distinguish disclosures by OTC and exchange traded derivatives
• Provide information on market activity by broad instrument category (futures, forwards, swaps, option, debt instruments)
• Provide information on market activity by broad risk category (interest rate, exchange rate, precious metals, other commodities and equities)
• Provide information by repricing date (maturity band)
Market risk – Quantitative disclosures
• Provide summary quantitative information on market risk exposure based on internal methods used for measurement, with information on performance in managing those risks

• Provide daily information on profits and losses on trading activities, combined with daily value at risk numbers
• Provide summary VAR results on a weekly or monthly basis
• For those disclosing VAR data, provide High/Low VAR
• For those disclosing VAR data, provide Average VAR
• Discuss the results of scenario analysis or impact of rate shocks for traded portfolios
• Discuss the number of times (days) actual portfolio loss exceeded VAR
• For non-traded portfolios: provide summary VAR or EAR
• For non-traded portfolios: provide summary results of scenario analysis of impact of rate shocks
Credit risk – Quantitative disclosure
• Discuss the gross current credit exposure (replacement cost)
• Discuss the potential future credit exposure
• Discuss the average credit exposure or range of credit exposure
• Discuss the credit exposure (i.e. replacement cost of derivatives) by maturity band
• Discuss the effect of credit enhancements on counterparty credit exposure
• Discuss the effect of legally enforceable netting agreements on credit risk exposure
• Provide the net credit exposure taking into account collateral and guarantees
• Provide the nominal and market value of collateral
• Provide information on counterparty credit quality by internal/external credit rating for significant concentrations
• Provide information on significant concentrations (e.g., by counterparty, industry, geographic location)
• Disclose the replacement cost of non-performing derivatives
• Disclose the credit losses on derivative instruments (if applicable)

• Provide information on reserves for derivatives contract credit losses
• If internal models are used, discuss the expected losses predicted by the model compared with actual results
• Disclose the notional amount of credit derivatives distinguished by protection sold/purchased and type (total return swap, credit default swap, or other credit derivative)
• Disclose the credit derivative exposure by reference asset
Liquidity risk – Quantitative disclosures
• Provide summary information about liquidity risk (e.g., concentrations and funding)
• Discuss the notional amount and market value of exchange traded and OTC contracts by market type and product (SIF)
• Provide gap schedule for both trading and non-trading derivatives
Other risks
• Disclose the legal risk – amount of current and potential loss exposure of contracts in dispute (if applicable)
Earnings – Trading activities
• Provide summary information about how trading activities affect earnings, based on internal measurement and accounting systems
• Provide information on revenues from trading activities
• Provide information on revenues by major risk category (fx, interest rate, commodity, equity) or by major product/ line of business (bonds, swaps, equities, etc.)
• Provide summary information about material trading gains from broad trading strategies (e.g., nonrecurring events or strategies that provide a significant portion of trading income)
• Provide summary information about material trading losses from broad trading strategies (e.g., nonrecurring events or strategies that provide a significant portion of trading income)

Earnings – Non-trading derivatives holdings
• Provide summary information about the effect on earnings of off-balance sheet positions held by the organisation (e.g., to manage interest rate risk, currency risk and other risks)
• Disclose the cumulative deferred losses on derivatives accounted for at historical cost
• Discuss the events that will result in recognition of these amounts
• Discuss the timing of recognition of deferred losses in the profit and loss account.
• Discuss the net gain or loss recognised in earnings from non-trading derivative activities and the category of income affected.
• Provide this information broken out by hedging strategy with the impact of hedge ineffectiveness separated
• Disclose the amount of deferred gain or loss recognised in earnings due to a change in assumptions about whether a firm commitment or anticipated transaction will occur
• Disclose the maximum period of time over which gains or losses are deferred