

**COMMISSION RECOMMENDATION****of 23 June 2000****concerning disclosure of information on financial instruments and other items complementing the disclosure required according to Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions***(notified under document number C(2000) 1372)**(2000/408/EC)*

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Article 211 thereof,

Whereas:

- (1) On the wider international level, banks and other undertakings are increasingly called upon to provide enhanced disclosure of their activities in financial instruments and other similar instruments.
- (2) This international development towards enhanced disclosure was echoed in the European Parliament's Resolution A4-0207/95 of 22 September 1995 on financial derivative instruments<sup>(1)</sup>.
- (3) Due to banks' and other financial institutions' pivotal role in financial markets and in the overall monetary and economic system, enhanced disclosure of information on activities relating to financial instruments and other similar instruments appears to be particularly desirable for these institutions.
- (4) Due to the enormous increase in these institutions' activities relating to such instruments, regarding notably derivative instruments, since the time of the adoption of Council Directive 86/635/EEC<sup>(2)</sup>, disclosure of additional information complementing the limited disclosure required under that Directive is considered necessary.
- (5) Disclosure of such information allows investors and market participants to take well-informed decisions, thus fostering market transparency and market discipline as a most valuable complement to prudential supervision.
- (6) To this effect, meaningful and comparable qualitative and quantitative information on institutions' activities relating to financial instruments and information on the objectives and methods of risk measurement and management systems is necessary.
- (7) Notwithstanding the obligation to disclose all material information, the potential usefulness of particular disclosures should be balanced against the need not to overburden financial statements with excessive disclosure and the likely cost of providing such information. The

obligation to disclose information does not impose an obligation to disclose confidential or proprietary information.

- (8) Given the ongoing international discussions on the methods for disclosing such information a formal amendment of Directive 86/635/EEC introducing mandatory disclosure requirements appears to be premature.
- (9) It is necessary for the smooth functioning of the internal market that the accounting information published by banks and other financial institutions remains sufficiently comparable. The Commission will therefore closely follow the effect of this recommendation on current practice in the Member States and will later, if necessary, propose further actions to ensure sufficient harmonisation in this field,

HEREBY RECOMMENDS:

1. For accounting periods commencing within 12 months from the date of this Recommendation and for all future accounting periods, information in accordance with the Annex should be disclosed by banks and financial institutions in the notes on the annual and consolidated accounts and/or in the annual report, as appropriate.
2. The Member States should take the appropriate measures to promote the application of this Recommendation, having due regard to the nature and size of particular institutions and the consequent usefulness to the market of the information provided in their accounts.
3. The Member States should notify the Commission of measures taken in compliance with this Recommendation.

Done at Brussels, 23 June 2000.

*For the Commission*

Frederik BOLKESTEIN

*Member of the Commission*<sup>(1)</sup> OJ C 269, 16.10.1995, p. 217.<sup>(2)</sup> OJ L 372, 31.12.1986, p. 1.

## ANNEX

**1. Scope and definitions**

- 1.1. Information on financial instruments, commodities and commodity-related derivative instruments (hereinafter: 'instruments') according to this recommendation should be disclosed by banks and financial institutions (hereinafter: 'institutions') which are subject of Council Directive 86/635/EEC in the notes on the annual and consolidated accounts and/or in the annual report, as appropriate.

The Appendices to this Annex set out illustrative examples of how this information might be disclosed to meet the objectives of this recommendation. These illustrative examples are not exhaustive. Other forms of disclosure, such as those based on in-house models, may also be used provided information on the basis of the models, including the reliability of information that stems from those models and whether they are recognised by the competent authorities for the purpose of calculating prudential capital requirements, is also disclosed.

- 1.2. A financial instrument is any contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party. Financial instruments include both
- primary financial instruments such as receivables, payables and equity securities and
  - derivative financial instruments such as options, futures, forwards, interest rate swaps and currency swaps, the value of which is derived from the price of an underlying financial instrument or a rate or an index or the price of an underlying other item.
- 1.3. A financial asset is any asset that is:
- (a) cash;
  - (b) a contractual right to receive cash or another financial asset from another party;
  - (c) a contractual right to exchange instruments with another party under conditions that are potentially favourable;  
or
  - (d) an equity instrument of another party.
- 1.4. A financial liability is any liability that is a contractual obligation:
- (a) to deliver cash or another financial asset to another party; or
  - (b) to exchange instruments with another party under conditions that are potentially unfavourable.
- 1.5. An equity instrument is any contract that evidences a residual interest in the assets of a party after deducting all of its liabilities.
- 1.6. Trading is the buying and selling of instruments with a view:
- to take advantage from variations or short term changes in market rates, indices or prices,
  - to facilitate customer transactions,
  - to hedge related trading positions.
- Other activities are non-trading.
- 1.7. Fair value is the amount at which an asset could be exchanged or a liability settled in a current transaction entered into under normal terms and conditions between independent, informed and willing parties, other than in a forced or liquidation sale.
- 1.8. Information according to this recommendation need not concern:
- (a) interests in subsidiaries;
  - (b) interests in associates;
  - (c) interests in joint ventures;
  - (d) employers' plans and obligations for post-employment benefits of all types, including retirement benefits;
  - (e) employers' obligations under employee stock option and stock purchase plans;
  - (f) obligations arising under insurance contracts;
  - (g) operating leases; take or pay contracts;
  - (h) own equity, own warrants and options on own shares.

## 2. **Materiality principle**

The recommendation's provisions need not be applied to immaterial items. In deciding whether instruments (either individually or in aggregate) are material, both the amount and the nature of the instruments should be taken into account.

Notwithstanding the obligation to disclose all material information, the potential usefulness of particular disclosures should be balanced against the need not to overburden financial statements with excessive disclosure and the likely cost of providing such information.

The level of detail to be disclosed should reflect the relative significance of activities, results and/or risks within the institution's overall business.

## 3. **Qualitative disclosure**

- 3.1. Qualitative information necessary for understanding the annual and consolidated accounts should be included in the notes to the accounts; other qualitative information should be included in either the notes to the accounts or elsewhere in the annual report.
- 3.2. Information should be disclosed in the annual report on the institution's risk management objectives and strategies reflecting its use of instruments within the context of its overall business objectives.
- 3.3. Information should be disclosed in the annual report on the policies and practice of managing the risks associated with trading and non-trading activities addressing the specific nature of the institution's exposure to, and its management of, credit risk, market risk (i.e. foreign exchange risk, interest rate risk, other price risks), liquidity risk and other risks of significance.
- 3.4. Information should be disclosed in the notes to the annual and consolidated accounts on all significant accounting policies relating to instruments.

## 4. **Quantitative disclosure — principles and general information**

- 4.1. Quantitative information necessary for the understanding of annual and consolidated accounts should be disclosed in institutions' notes to the annual and consolidated accounts. Other quantitative information should be included elsewhere in the annual report. Furthermore, the fair values of instruments held for trading, both on and off the balance sheet, should be disclosed where they differ materially from the amounts at which they are included in the accounts.
- 4.2. Where disclosure of quantitative information draws on institutions' internal risk management systems and the methods used within those systems (e.g. sensitivity analysis, VAR models) it is not necessary for the disclosure to be such as to disseminate information relating to those systems and methods that could be seriously prejudicial to the institution.
- 4.3. Appropriate analysis should be provided of trading and non-trading instruments, including information on the level of activity in the institution with respect to those instruments. The analysis should reflect in particular significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

## 5. **Quantitative disclosure — information on credit risk**

- 5.1. Information on credit risk should be disclosed on the basis of the amount that best represents the maximum credit risk exposure at the balance sheet date (net of any netting agreements that are legally enforceable by the institution) without taking account of any collateral. Information on the maximum credit risk exposure should be complemented by information on the potential credit risk exposure taking into account collateral and other netting agreements.

If the carrying amount of an instrument represents the maximum credit risk exposure, disclosure of additional information, for the purposes of this paragraph, is not necessary.

- 5.2. Information should be disclosed on significant concentrations of credit risk from on- and off-balance-sheet exposures by economic sector and geographic location, for example, by different industry sectors, individual countries or groups of countries.

## 6. **Quantitative disclosure — information on market risk**

- 6.1. Information on market risk should be disclosed on the basis of value-at-risk, sensitivity analysis or other market price risk measure.
- 6.2. The different methods should be used alternatively or in combination in such a way as to provide a comprehensive picture of the institution's exposure to market risks inherent in its positions in trading and non-trading instruments. Where practicable, separate disclosures should be provided for each type of market risk.

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Appendix 1

(This Appendix is purely illustrative and does not form part of the recommendation)

**Information in relation to qualitative disclosure**

- (a) The basic features of management of risks including in particular the assessment and measurement of risk; if applicable, the internal limit system and the avoidance of undue concentrations of risk.
- (b) The activities in instruments used for trading purposes.
- (c) The activities in instruments used for non-trading purposes, reflecting in particular hedging policies.
- (d) The activities in high-risk instruments or complex instruments such as leveraged derivative instruments.
- (e) The use of collateral.
- (f) The use of netting agreements.

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Appendix 2

(This Appendix is purely illustrative and does not form part of the recommendation)

**Disclosure of information in relation to accounting principles adopted**

- (a) Information on the method of applying these principles to:
    - trading and non-trading instruments and their eventual reclassification,
    - specific relationships between different instruments (e.g. synthetic instruments, hedging, termination of hedges, hedging by internal transactions, hedging of anticipated transactions),
    - specific types of instruments or related transactions (e.g. disclosure may be necessary in particular for securitisations; repurchase and reverse repurchase agreements; in-substance defeasance), and
    - primary instruments with embedded financial derivatives.
  - (b) The information disclosed might also include:
    - (i) the criteria applied for recognition and derecognition of instruments in the balance sheet;
    - (ii) the basis for valuation of the different types or classes of instruments at inception and subsequently;
    - (iii) the methods used for determining fair value of instruments (e.g. on the basis of quoted market prices, use of bid/ask/mid prices, discounted cash flow analysis, estimation techniques or some other appropriate method) including the significant assumptions made in applying these methods;
    - (iv) in cases where determination of fair value is based on quoted market prices the nature of the adjustments made to these prices, if any;
    - (v) the methods used for including in the profit and loss account gains and losses, interest and other items of income and expense associated with trading and non-trading instruments addressing in particular the recognition of income;
    - (vi) policies adopted in cases of hedging and termination of hedging relationships.
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Appendix 3

(This Appendix is purely illustrative and does not form part of the recommendation)

**Disclosure of complementary information to aid better understanding of quantitative information**

Provision of complementary information on the terminology and the presentation forms used, on risk measurement methods, related assumptions and, as appropriate, other parameters can assist readers of financial statements better to understand the quantitative information supplied.

Where average values are disclosed the intervals used to arrive at those averages can also assist readers of financial statements better to understand the information supplied. If the year end figure is not representative of average values, average values can further assist understanding.

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Appendix 4

(This Appendix is purely illustrative and does not form part of the recommendation)

**Disclosure of quantitative information**

1. Quantitative information may be disclosed in tabular form including in particular:
    - A. As an indication, *inter alia*, of the level of activity, with respect to primary instruments on the carrying amount:
      - (i) broken down on the vertical axis into the different classes of instruments distinguishing between assets and liabilities, and
      - (ii) broken down on the horizontal axis into residual maturities, with additional indication of fair value of trading totals.
    - B. As an indication, *inter alia*, of the level of activity with respect to derivative instruments, on the notional amount:
      - (i) broken down on the vertical axis into the different classes of derivative instruments (e.g. interest rate, foreign exchange and gold, equities, precious metals except gold, other commodities, other), further subdivided into:
        - OTC derivative instruments (with subcategories e.g. forwards, swaps, options purchased/written), and
        - exchange traded derivative instruments (with as sub-categories e.g. futures long/short, options purchased/written); and
      - (ii) broken down on the horizontal axis into residual maturities with additional indication of fair value of trading totals.
    - C. Time bands that are relevant for the information disclosed may be used, for example:
      - (i) not more than three months;
      - (ii) more than three but not more than six months;
      - (iii) more than six months but not more than one year;
      - (iv) more than one year but not more than five years;
      - (v) more than five years.

Subject to materiality, the time bands specified may be further broken down (e.g.  $\leq$  one month;  $>$  one  $\leq$  three months) or merged to larger time bands (e.g.  $\leq$  one year;  $>$  one and  $\leq$  five years;  $>$  five years) as appropriate.
    - D. As an indication, *inter alia*, of the level of activity in terms of fair value as opposed to the carrying amount, information may be disclosed in tabular form distinguishing between assets and liabilities
      - on carrying amounts and fair values of classes of trading instruments, and
      - for trading instruments, on average-of-period fair values, and:

if the determination of fair value is not possible, practicable or reliable, additional information on the principal characteristics of the instrument that may affect its fair value.
  2. The above information could also be disclosed in tabular form combining the tabular formats set out above.
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Appendix 5

(This Appendix is purely illustrative and does not form part of the recommendation)

**Credit risk disclosure**

With respect to the credit risk exposure from OTC derivative instruments, information may be disclosed in tabular form:

- broken down on the vertical axis into different degrees of credit worthiness of counterparties assessed on the basis of internal or external ratings; and
- broken down on the horizontal axis into
  - gross replacement costs,
  - net replacement costs if enforceable netting agreements exist,
  - potential future credit exposure.

Undertakings that calculate the credit risk of OTC derivative instruments on the basis of the original risk method may disclose only the information that is obtained by applying the said method.

Information on the potential future credit exposures may be complemented by a discussion of the related estimation techniques.

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Appendix 6

(This Appendix is purely illustrative and does not form part of the recommendation)

**Market risk disclosure**

Information on market risk arising on instruments may be given on any of the following basis.

- A. Value at risk information.
- B. The potential effect on future earnings of selected hypothetical changes in market prices and rates. The hypothetical changes used should be reasonably possible during the 12 months following the date on which the annual or consolidated accounts are approved. One of these hypothetical changes might usefully include an adverse change of at least 10 % in the year-end market prices or rates (unless such a change may be demonstrated not to be reasonably possible).
- C. A market price measure, other than those covered by A and B provided that:
  - (i) the institution's management uses the model from which the measure has been derived for the purpose of managing the market price risk arising from the use of trading instruments; and
  - (ii) the model has been recognised for the purpose of providing capital adequacy returns to the prudential regulator.
- D. An analysis of the aggregate fair values by major categories of financial assets and financial liabilities arising from trading instruments and, within those categories, by time bands according to the earlier of the period to the next interest rate repricing or the maturity date.

Time bands that are relevant for the information disclosed may be used, for example:

- (i) not more than three months;
- (ii) more than three but not more than six months;
- (iii) more than six months but not more than one year;
- (iv) more than one year but not more than five years;
- (v) more than five years.

If the value at risk, sensitivity analysis or other market price risk measure figures disclosed are not typical of the figures during the financial year, then additional figures provided to put the figures at the balance sheet date in context can assist readers of financial statements to better understand the information supplied. These additional figures might be either the average values or the highest and lowest.

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