FSB TRANSPARENCY INITIATIVES

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Starting in the summer of 2007, the world experienced financial market turmoil that grew into a global financial crisis, and challenging international market conditions have persisted in its aftermath. Over this period, the Financial Stability Board (FSB) (and, up to April 2009 its predecessor, the Financial Stability Forum (FSF)), has been called upon by the leaders of the G20 countries to analyze the causes of the international market turmoil and to agree coordinated financial reforms that address core problems and lay the foundations to strengthen market and institutional resilience and promote financial stability.[1] As part of this work, G20 leaders asked the FSF to conduct an analysis of procyclicality in the financial system and recommend policy options to mitigate it. Efforts to enhance transparency have been an important part of coordinated financial reforms, including through convergence activities of the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB).

This article summarizes the key financial stability initiatives of the FSB that seek to enhance transparency and move toward improved global accounting and auditing standards and practices.

1 Prior to the financial crisis

The FSB and its predecessor FSF recognized the importance of promoting transparency by encouraging high quality international accounting and auditing standards and practices, and improved disclosure practices. These enhance the quality of information available to investors and other market participants, regulators and prudential authorities, which can help to improve market discipline, reinforce sound risk management practices and improve the consistency of capital measures and ratios. External audits performed in accordance with high quality auditing standards can promote appropriate implementation of accounting standards by firms and help to enhance market confidence by providing assurance that the financial statements are presently fairly in accordance with the relevant accounting framework. Moreover, through interaction with firms' governance and management processes, sound audits can help reinforce strong corporate governance and internal controls at firms and, in certain cases, more reliable supervisory reports. Together with effective supervision and other factors, the above can help to foster safe and sound banking systems and more stable financial markets.

The IASB Chairman has long been a member of the FSF and FSB, serving on both the FSB Plenary – its policy making body – and its Steering Committee. Also, the International Financial Reporting Standards (IFRS) of the IASB and the International Standards on Auditing of the International Auditing and Assurance Standards Board (IAASB) are among the key standards for sound financial systems designated by the FSB as deserving of priority implementation, because of their importance for financial stability.[2]

1 The FSB was established in April 2009 to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSB is chaired by Mark Carney, Governor of the Bank of Canada. Its Secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements. For further information on the FSB, visit the FSB website, www.financialstabilityboard.org.

2 See http://www.financialstabilityboard.org/cos/key_standards.htm.

In the years preceding the financial crisis, the FSF carefully considered the IASB's progress in developing and improving its main standards affecting financial institutions, as well as important accounting and auditing developments and issues arising in its member jurisdictions.

– The FSF called for the establishment of the Public Interest Oversight Board to provide independent oversight to the international audit standard-setting activities of the International Federation of Accountants (IFAC), and was a strong supporter of the Monitoring Group that worked with IFAC in the development of reforms of its standard-setting activities in 2003. The FSB continues this work as a member of the Monitoring Group.

– The FSF also encouraged the establishment of independent auditor oversight regimes and promoted cooperation among audit oversight authorities (also called audit regulators). The FSF strongly supported the formation of the International Forum of Independent Audit Regulators (IFIAR), recognizing the role it could have in enhancing communication and coordination among audit regulators and bringing more consistency to global audit regulation over time.

– Moreover, the FSF conducted joint international roundtables in 2004 and 2006 together with the IASB and IFAC on ways to improve international accounting and auditing practices.

In addition, the FSF maintained dialogue with leading global financial institutions and audit firms on important international accounting, auditing and disclosure issues affecting financial markets such as valuation, impairment, off-balance sheet entities and related risk management and control practices.

2 Initial recommendations in early 2008 as the market turmoil deepens[3]

In October 2007, the G7 Finance Ministers and Central Bank Governors asked the FSF to undertake an analysis of the causes and weaknesses that produced the market turmoil and to set out recommendations for increasing the resilience of markets and institutions, and to report to their meeting in Washington in April 2008.

The findings and recommendations in the FSF's report in April 2008 were the product of an intensive collaborative effort of the main international bodies and national authorities in key financial centers. To address the G7 request, the FSF formed a senior working group from among its membership. They drew on a large body of coordinated work, comprising that of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the IASB, the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centers. In addition, insights had been gained from private sector market participants.

To restore confidence in the soundness of markets and institutions and enhance the resilience of the global financial system, the FSF proposed concrete actions in the following five areas:

3 "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 2008. See www.financialstabilityboard.org/publications/r_0804.pdf.

- Strengthened prudential oversight of capital, liquidity and risk management;

- Enhancing transparency and valuation;

- Changes in the role and uses of credit ratings;

- Strengthening the authorities' responsiveness to risks; and

- Robust arrangements for dealing with stress in the financial system.

In order to enhance transparency and valuation, the FSF report encouraged a number of actions, including needed risk disclosure, valuation and accounting convergence reforms. In assessing challenging situations during the market turmoil, the FSF found that:

- Weaknesses in public disclosures by financial institutions had damaged market confidence. Public disclosures that were required of financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures. There were also shortcomings in the other types of information firms provided about market and credit risk exposures, particularly as these related to structured products. Where information was disclosed, it was often not done in an easily accessible or usable way.

- The turbulence revealed the potential for adverse interactions between high leverage, market liquidity, valuation losses and financial institutions' capital. For example, write-downs of assets for which markets were thin or buyers were lacking raised questions about the adequacy of capital buffers, leading to asset sales, deleveraging and further pressure on asset prices. Poor information availability reinforced these adverse feedback loops.

The market turmoil highlighted the importance to market confidence of reliable valuations and useful disclosures of the risks associated with structured credit products and off-balance sheet entities. To address these particular issues, the FSF report called for specific actions by market participants, standard-setters, supervisors and regulators relating to:

- Risk disclosures by market participants;

- Accounting and disclosure for off-balance sheet entities;

- Valuation; and

- Transparency in securitization processes and markets

These recommendations are summarized in Box 1.

OVERVIEW OF FSF-RECOMMENDED INITIATIVES IN 2008 TO ENHANCE TRANSPARENCY AND VALUATIONS BOX 1

Robust risk disclosures:

- The FSF strongly encouraged financial institutions to make robust risk disclosures using leading disclosure practices (summarized in the FSF report), at the time of their mid-year 2008 reports.
  - The private sector should jointly develop principles for relevant risk disclosures and identify leading risk disclosure practices based on current market conditions and risk at the time of the disclosure.
- Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II was issued by the BCBS in 2009.

Standards for off-balance sheet vehicles and valuations:

Relevant standard setting bodies took urgent action to:

- Improve and converge financial reporting standards for off-balance sheet vehicles;
- Develop accounting, supervisory and auditing guidance on valuations when markets are no longer active, including calling for the establishment of an IASB expert advisory panel on valuations.

Transparency in structured products:

- Market participants and securities regulators took steps to expand the information provided about securitized products and their underlying assets.

Improved risk disclosure and valuation by market participants

The FSF's first recommendation strongly encouraged financial institutions to make robust risk disclosures using leading disclosure practices at the time of their upcoming mid-year 2008 reports. These leading-practice risk disclosures were summarized in the FSF report and based on a survey by the Senior Supervisors Group (SSG) of end-2007 risk disclosures for selected exposures that the marketplace considered to be high-risk or involve more risk than previously thought.[4, 5] Specifically, the FSF recommended robust, consistent disclosures about the following types of exposures:

- Collateralized debt obligations, including related hedges;
- Other subprime and Alt-A exposures;
- Special purpose entities (SPEs);
- Commercial mortgage-backed securities; and
- Leveraged finance exposures.

The report stressed that these disclosures should be made by financial institutions for significant risk exposures. FSB communicated the FSF recommendations to financial institutions in their jurisdictions and encouraged enhanced disclosure practices for those with significant exposures. In response to the recommendations by the FSF and others,

4 Senior representatives of eight supervisory authorities from five countries (collectively the "Senior Supervisors Group" or SSG) joined in issuing a report to the FSF that reviewed the disclosure practices of financial services firms concerning their exposures to certain financial instruments that the marketplace in early 2008 considered to be high-risk. The SSG analyzed year-end 2007 disclosures by a sample of large internationally-oriented banks and securities firms, in its report to the FSF, *Leading-Practice Disclosures for Selected Exposures,* April 2008.

5 The term "leading" was used by the FSF and SSG to mean most informative, both as regards quantity and quality of information (e.g., the data would enable market participants to assess the risks and returns of investments in or exposures to the firm; so that market participants can properly understand data that are disclosed). The proposed disclosures were intended to supplement rather than replace existing risk disclosures, including those required under Pillar 3 of Basel II. The FSF noted that, in this context, disclosure broadly included not only information presented in public securities filings but also information presented in earnings press releases and accompanying presentation slides posted to the firms' internet websites.

many large banks started to provide more meaningful and consistent quantitative and qualitative information about structured credit risk exposures, valuations, off-balance sheet entities and related policies from mid-2008.[6]

A second set of principles-based recommendations included in the FSF report encouraged investors, financial industry and auditors to work together to provide principles and leading practice risk disclosures that would be most relevant to market conditions at the time of disclosure. This would help keep disclosures fresh and reflective of the risks truly being faced at those future reporting dates, and avoid institutions focusing undue attention on making supplemental disclosures focusing on yesterday's risk issues that are no longer relevant to the marketplace.

Third, the FSF report called on financial institutions to establish rigorous valuation processes and make robust valuation disclosures. To this end, they should:

- Establish rigorous and timely processes to apply critical expert judgment and discipline in how they value holdings of complex or illiquid instruments (avoiding undue reliance on ratings and consensus pricing services);

- Maintain sound governance and control practices associated with valuation processes, including those that deal with hard-to-observe inputs to valuation models, model validations, price verification and related audit programs; and

- Enhance the quality of their disclosures about valuations, valuation methodologies, price verification processes and the uncertainty associated with valuations.

BCBS initiatives requested by the FSF

The FSF's work spurred additional measures by banking supervisors to enhance transparency. The BCBS issued in 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II, for example, for securitization exposures, off-balance sheet entities, liquidity commitments to asset-backed commercial paper conduits and valuations.

Also, the BCBS issued supervisory guidance for assessing banks' financial instrument fair value practices in April 2009. The principles in this supervisory guidance promote strong governance over valuation processes; the use of reliable, diverse information sources for valuation inputs; the communication of valuation uncertainty to internal and external stakeholders; independent verification and validation processes; consistency in valuation practices for risk management and reporting purposes, where possible; and strong supervisory review of bank valuation practices.

Initiatives by accounting and auditing standard setters

Accounting and auditing standard-setters also took forward the FSF's initiatives. In response to the FSF's recommendations to enhance transparency and valuation, the IASB implemented a number of key projects. Given the importance of these initiatives, these projects were undertaken on an accelerated timetable.[7]

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6 The FSB Thematic Review on Risk Disclosure Practices, March 2011, found that this has improved risk disclosure practices related to structured credit activities, including exposures to SPEs, asset-backed securities, mortgage-backed securities and collateralized debt obligations. See http://www.financialstabilityboard.org/publications/r_110318.pdf.

7 At the time of the development of the FSF report, the IASB due process requirements resulted in significant time to propose and finalize standards and the IASB did not have procedures for accelerating projects. Such procedures were later approved by the trustees overseeing the IASB, now called the IFRS Foundation.

- In October 2008 the IASB enhanced its guidance on valuing financial instruments when markets are no longer active, based on the findings of an expert advisory group on valuation that it had established in June 2008.[8] The IASB also issued proposals to strengthen disclosures about valuations and related governance, controls, methodologies and uncertainties.

- Moreover, as mentioned in the FSF recommendations, the IASB developed proposals to enhance its standards on consolidation of off-balance sheet entities and related risk disclosures and finalized these proposals during 2009 to 2011.

Furthermore, the FSF report indicated that the IAASB, major national standard setters and relevant regulators should enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures, where necessary. The report recommended that the largest global audit firms provide input to this process by sharing their audit approaches in addressing auditing and financial reporting issues resulting from the market turmoil and which could be used for enhancing auditing guidance. The IAASB issued a Staff Audit Practice Alert in October 2008 on audits of valuations and complex products and also discussed these issues with the largest international audit firm networks to encourage improved practices.[9]

The FSF report also called for the IASB and the US FASB to converge their standards and guidance in key areas. In addition, as discussed below, the calls from the marketplace for convergence strengthened as the financial crisis deepened.

In addition to recommendations in the reports of the FSF and FSB, the FSB supported dialogue to foster better understanding and communication with respect to important international accounting, auditing and risk disclosure issues, including the following:

Senior official dialogue:

- The FSB Chairman, Secretary General and senior advisor maintained dialogue with the Chairmen of the IASB, U.S. FASB and IAASB on key developments in projects of interest to the FSB.

- The FSB supported the IASB in maintaining enhanced technical dialogue with senior representatives of its member bodies and with the accounting committees of IOSCO, the BCBS and IAIS.

- The FSB conducted roundtables and other focused meetings to foster dialogue between senior officials in the private and public sectors on important accounting, auditing, and risk disclosure developments and issues.

8 This IASB guidance was issued in the following report: www.ifrs.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf.

9 Following, in part, from the FSF recommendation to the IAASB and other audit authorities, in 2009 and 2010 the IAASB proposed improvements in its audit guidance for complex financial instruments that draws attention to relevant aspects of accounting for fair value measurement and related disclosures and practical considerations when auditing such instruments. The IAASB finalized this as IAPN 1000.

Technical dialogue:

- The FSB senior advisor participated in (a) the IASB-FASB Financial Crisis Advisory Group; (b) the IASB Expert Advisory Panel on Valuations and (c) the IASB Expert Advisory Panel on Impairment.

- The FSB Secretariat maintained ongoing technical dialogue with the IASB and FASB project experts on key aspects of their convergence progress.

3 The G20 Leaders and FSB on procyclicality, convergence and transparency

In its April 2008 Report, the FSF noted that it would examine the forces that contribute to procyclicality in the financial system and develop options for mitigating it. At the G20 Leaders Summit in London in April 2009, the FSF issued a report, “Addressing Procyclicality in the Financial System”.[10]

The term “procyclicality” refers to the dynamic interactions between the financial and the real sectors of the economy. These mutually reinforcing interactions tend to amplify business cycle fluctuations and cause or exacerbate financial instability. The global financial crisis was a graphic example of the disruptive effects of procyclicality. Institutions that experienced extensive losses faced growing difficulties in replenishing capital. This, in turn, induced them to cut credit extension and dispose of assets. Their retrenchment precipitated a weakening of economic activity, thereby raising the risk of a further deterioration in their financial strength. Addressing procyclicality in the financial system is an essential component of strengthening the macroprudential orientation of regulatory and supervisory frameworks.

The FSF report examined the forces that contribute to procyclicality in the financial system, and explored possible mitigating actions in three main areas: (i) the Basel II capital accord; (ii) loan loss provisioning; and (iii) valuation and leverage, including margining practices. The recommendations in the report were the result of collaborative work involving national authorities, the BCBS, BIS, CGFS, IMF, IOSCO, the IASB and the U.S. FASB.

At the London summit meeting, the FSF was re-established as the FSB with a broadened mandate to promote financial stability. The G20 Leaders welcomed the accounting recommendations in the FSF’s procyclicality report and requested action by accounting standard-setters.[11] The G20 Leaders also called on “the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards”.[12] Specifically, the G20 Leaders encouraged accelerated efforts by the IASB and FASB to finalize improved, converged accounting standards and efforts to enhance the governance of the IASB.

The G20 Leaders requested that the FSB monitor implementation efforts, including those addressing accounting issues. Starting with its progress reports to the G20 Leaders in September 2009, the FSB has included recommendations on accounting matters in its communications with the G20, including an assessment of IASB-FASB convergence progress. Box 2 provides an example of FSB recommendations on impairment and valuation presented in its progress report to the G20 Leaders at the Pittsburgh Summit in September 2009.

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10 See www.financialstabilityboard.org/publications/r_0904a.pdf.
11 G20 Leaders, “Declaration on Strengthening the Financial System – London Summit, 2 April 2009”.
12 G20 Leaders, “London Summit – Leaders’ Statement, 2 April 2009”.

31. Moreover, continuing differences in accounting requirements of the IASB and FASB for netting/offsetting of assets and liabilities also result in significant differences in banks' total assets, posing problems for framing an international leverage ratio.

32. Therefore, additional work in the areas above is urgently needed in order to meet the important objectives of convergence, transparency and the mitigation of procyclicality, as standard setters continue their efforts to improve the quality of their standards and reduce the complexity of their standards on financial instruments.

33. We strongly encourage the IASB and FASB to agree on improved converged standards that will:

– incorporate a broader range of available credit information than existing provisioning requirements, so as to recognize credit losses in loan portfolios at an earlier stage as part of an effort to mitigate procyclicality. We are particularly supportive of continued work on impairment standards based on an expected loss model; and
– simplify and improve the accounting principles for financial instruments and their valuation. We are particularly supportive of continued work in a manner that does not expand the use of fair value in relation to the lending activities (involving loans and investments in debt instruments) of financial intermediaries.

34. While respecting the independence of accounting standard setters, the FSB is urging renewed efforts by the IASB and FASB to achieve these objectives, working with supervisors, regulators and other constituents. The Basel Committee has issued for consideration by accounting standard setters principles for the revision of accounting standards for financial instruments, agreed by all G20 banking supervisors, that address issues related to provisioning, fair value measurement and related disclosures.

35. We welcome the IASB's recent initiatives with respect to provisioning and its enhanced technical dialogue with prudential supervisors and other stakeholders, and encourage the IASB to continue its dialogue with stakeholders as it moves forward. We request G20 Leaders to support the call for action set forth in this section.

Encouragement to consider expected loss provisioning

The call of the G20 Leaders to the IASB and FASB to enhance accounting for loan loss "impairment" or "provisioning", was largely encouraged by FSF/FSB work at that time. Under both IASB standards (called International Financial Reporting Standards or IFRS) and FASB standards (called generally accepted accounting principles or GAAP), the accounting model for recognizing credit losses is commonly referred to as an "incurred loss model" because the timing and measurement of losses is based on estimating losses that have been incurred as of the balance sheet date. Provisioning requirements in IASB and FASB standards thus generally limit provisioning to losses that are considered probable as of the balance sheet date. In addition, these accounting standards do not permit credit losses based on events that are expected to occur in the future to be included in provisions until the event or events that would probably result in a loss have occurred, generally supported by observable evidence (e.g., borrower loss of employment, decrease in collateral values).

While the incurred loss model had been ingrained in the thinking of standard-setters for many years, the experience of the financial crisis highlighted problems, particularly with the delayed recognition of credit losses caused by the incurred loss standards. These delays resulted in the recognition of credit losses that were widely regarded as "too little, too late".

New thinking was needed, based on lessons from the financial crisis, to reform the accounting approach in this area in a manner that would support the overall goal of improving transparency. The FSF Working Group on Provisioning, co-chaired by Kathleen Casey, Chairman of IOSCO's Technical Committee and SEC Commissioner, and by John Dugan, Chairman, Joint Forum, and US Comptroller of the Currency, brought together securities regulators, banking supervisors, accounting standard-setters and audit regulators to evaluate this key area. Both U.S. and international accounting perspectives were carefully explored. The IASB and FASB were fully involved, as were BCBS representatives and the chairmen of IFIAR and the U.S. Public Company Accounting Oversight Board. The working group also engaged in outreach involving investors, external auditors and financial institutions. This effort helped to ensure that the group's findings would address needs of investors while also addressing certain key prudential objectives.

In April 2009, based on the working group's recommendations, the FSF's procyclicality report to the G20 noted that: "Earlier recognition of loan losses could have dampened cyclical moves in the current crisis... Earlier identification of credit losses is consistent both with financial statement users' needs for transparency regarding changes in credit trends and with prudential objectives of safety and soundness." The FSF report recommended: "The FASB and IASB should reconsider the incurred loss model by analyzing alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information."

In its progress report to the G20 Leaders in September 2009, the FSB noted that, "We are particularly supportive of continued work on impairment standards based on an expected loss model". [13]

This encouragement has led to valuable work by the accounting standard setters. The IASB proposed an expected loss impairment or provisioning model in November 2009. The FASB, after first proposing in May 2010 a modified version of the incurred loss model, has been working jointly with the IASB since early 2011 on clarifying and finalizing an expected loss impairment approach.

Encouragement to further improve financial instruments and valuation standards

As previously mentioned, the FSF procyclicality report in April 2009 had also involved an assessment of valuation and leverage issues. The report found that:

> "The extensive use of fair value accounting encouraged market practices that contributed to excessive risk-taking or risk-shedding activity in response to observed changes in asset prices. In the course of the present crisis, this mechanism became clear at times of adverse market dynamics, particularly as liquidity in financial markets evaporated. When the markets for many credit risk exposures became illiquid over 2007-08, credit spreads widened substantially as liquidity premia grew. Wider spreads drove down mark-to-market valuations on a range of assets. Some fair valued assets that became illiquid were marked down to match declines in traded derivative indices.
>
> The extensive use of fair value accounting meant that, across the financial system, these declines in valuations translated into lower earnings or accumulated unrealised losses in the equity account for securities held for sale. Mark-to-market losses eroded banks' core capital, causing balance sheet leverage to rise. Banks sold assets in an attempt to offset this rise in balance sheet leverage and to address liquidity issues, but such sales only pushed credit spreads wider, causing more mark-to-market losses."

This effort resulted in two sets of accounting recommendations, summarized below, which were developed with input from the IASB, IOSCO, the SEC, and the BCBS.

13 "Improving Financial Regulation, Report of the Financial Stability Board to G20 Leaders", September 2009.

- Accounting standard setters and prudential supervisors should examine the use of valuation reserves or [valuation] adjustments for fair valued financial instruments when data or modeling needed to support their valuation is weak.[14]

- Accounting standard setters and prudential supervisors should examine possible changes to relevant standards to dampen adverse dynamics potentially associated with fair value accounting. Possible ways to reduce this potential impact include the following:

  - Enhancing the accounting model so that the use of fair value accounting is carefully examined for financial instruments of credit intermediaries.

  - Transfers between financial asset categories.

  - Simplifying hedge accounting requirements.

In its progress report to the G20 Leaders at the Pittsburgh Summit in September 2009, the FSB noted that it was particularly supportive of standards that would not expand the use of fair value in relation to the lending activities of financial intermediaries. Considering the views of stakeholders, the IASB issued IFRS 9, "Financial Instruments", in November 2009 which includes an amortized cost category for financial assets such as loans and certain investments in debt securities. The other aspects of the above recommendations have been reflected by the IASB in IFRS 9 and IFRS 13, "Fair Value Measurement", as well as in the IASB's planned new hedge accounting standard, which seeks to simplify hedge accounting requirements in ways that are more consistent with companies' risk management practices.

In early 2010 it looked as though divergent accounting standards for lending activities might arise, due to a FASB proposal to use fair value measurement on the balance sheet and through "other comprehensive income" for loans and investments in debt securities. Under this proposal, changes in fair values of lending instruments would affect reported shareholders' equity, but generally would not be included in profit and loss. However, in response to FASB's request for feedback from interested parties on the proposal, and based upon extensive outreach by the FASB, the majority of investors and other stakeholders indicated they did not agree with the fair value measurement recognition aspects of that proposal as it relates to lending activities, deposits, and other liabilities. The FASB has since moved away from this proposal, and has decided in its revised approach to use amortized cost as a measurement basis for loans.

FSB monitoring of IASB-FASB convergence progress

Starting in 2009 the FSB has been reporting to the G20 Leaders on progress in implementing the recommendations of the G20 and the FSB, including those on accounting matters. Progress has been achieved so far in many of these areas. For example:

- *Measurement of loans.* As discussed above, both the IASB and the FASB have decided that their financial instruments accounting standards will use amortized cost as a measurement basis for loans, moving away from an earlier FASB proposal to require fair value measurement for loans.

14 The report noted that, "Standard setters and supervisors should explore whether firms should be required to hold valuation reserves or to otherwise adjust valuations to avoid overstatement of income when significant uncertainty about valuation exists. For financial instruments that are not actively traded, insufficient market depth or reliance on valuation models using unobservable inputs that are difficult to verify may create considerable valuation uncertainty."

– *Loan provisioning/impairment.* Following the above recommendations of the FSB, both Boards are seeking to develop and finalize an expected loss approach for impairment that should lead to more robust, forward-looking impairment practices that are intended to result in an earlier recognition of credit losses based on consideration of all available information about credit quality and trends.

– *Off-balance sheet entities.* The FSB has encouraged improved IASB accounting and disclosure standards for off-balance sheet vehicles. The IASB's final disclosure standards in 2011 enhance information about risk exposures that remain when a financial asset has been derecognized (e.g. securitized), including improved information about unconsolidated structured entities, and are broadly aligned to FASB disclosure requirements.[15]

– *Addressing valuation uncertainty in fair value measurement guidance.* The FSB recommended that standard setters and supervisors explore whether firms should be required to hold valuation reserves or to otherwise adjust valuations to avoid overstatement of income when significant uncertainty about valuation exists. Final improved IASB and FASB fair value measurement standards in 2011 have aligned requirements about how to measure fair value, including guidance on measurement when markets become less active, and to address valuation uncertainty.

– *Repurchase agreements.* The FSB had expressed concern that the IASB's consultation proposal on derecognition would require repurchase agreements to be treated as sales and forward contracts in certain situations (thus leading to off-balance-sheet treatment), instead of as financing transactions on the balance sheet as under current IFRS. The IASB decided not to move forward with its proposal. The FASB has also taken steps to review its accounting for repurchase agreements and plans steps in 2012 that could further converge its approaches with those of the IASB, for example, by eliminating "repo-to-maturity" accounting approaches under FASB standards which result in off-balance sheet treatment for those transactions.[16]

– *Risk disclosures.* As a result of the efforts of the two Boards, improved risk disclosure requirements are in place. However, not all are converged at this time.

While progress has been made toward improved, converged standards, the convergence process is taking longer than initially expected in some areas, such as classification, measurement and provisioning, and it appears that the Boards are diverging with respect to their ongoing projects on hedge accounting. The FSB has encouraged the Boards to redouble their efforts to seek converged standards in these important areas.

15 In their joint update report on convergence progress to the the FSB and G20 in April 2012, the IASB and FASB said, "The boards have completed their respective consolidation projects, which included addressing issues about the consolidation of special purpose entities and enhanced disclosures about off balance sheet risks. The new IFRS requirements will also bring into force new disclosure requirements relating to structured entities (special purpose entities), making IFRS and US GAAP disclosure requirements similar. Differences remain, however, in relation to what US GAAP refers to as voting interest entities; US GAAP has a legalistic approach to defining control, whereas the new IFRS has a broader definition of control, including effective control. On the basis of feedback received, the FASB also decided to expose the principal-agent sections of the IFRS model." This joint report can be found on the FSB website. See www.financialstabilityboard.org/publications/r_120420d.pdf.

16 For a summary explanation of the accounting treatment for repo-to-maturity transactions and concerns about their use at MF Global, see www.cnbc.com/id/45132384/The_Trade_That_Killed_MF_Global,

The netting/offsetting of derivative contracts and other financial assets and financial liabilities is another area where the FSB has expressed concerns. In this case, where different approaches result in significant differences in the total assets of large financial institutions, the Boards decided to maintain their different current offsetting *accounting* rules while issuing at end-2011 new requirements for common *disclosures* about gross and net positions for derivatives and other financial instruments to improve transparency. This follows the Boards' issuance of a joint proposal in January 2011 on a converged accounting approach to balance-sheet netting. However, instead of the 2011 proposal, comments from the U.S. generally supported the current FASB netting rules and those using IFRS generally supported current IASB rules, with many investors seeking both gross and net information. Derivatives dealer banks, both inside and outside the U.S., generally wanted the FASB (net) accounting approach in order to avoid the massive grossing-up of their balance sheets.

The FSB noted a concern in this area was that differences in offsetting/netting accounting standards would adversely affect the efforts to develop an internationally comparable leverage ratio for capital purposes. However, while the IASB and FASB have decided to maintain their different accounting rules for netting/offsetting, the FASB netting approach and the netting approach that will be carried forward to the Basel III international leverage ratio are similar in their effect because both recognize netting/offsetting based on legally enforceable master netting agreements. Thus, from a bank supervisory perspective, there may be more convergence for leverage ratio purposes than is first apparent.

Some were concerned that the IASB and FASB have revised their target completion dates for their remaining convergence projects so that they extend into 2013, beyond the end-2011 date called for earlier by the G20. The FSB reported to the G20 in April 2012 that the IASB and FASB will conduct further public consultations in the second half of 2012, and expect to issue final converged standards in a number of key areas by mid-2013. The two Boards mentioned that they have extended certain project target completion dates in order to allow sufficient time for outreach and public comment on the large number of planned major Exposure Drafts, and for the Boards to reflect that feedback in high-quality final standards. The FSB reported to the G20 that it supports the efforts of the IASB and FASB to achieve convergence to a globally accepted set of high-quality accounting standards and urges them to issue final converged standards on key projects by mid-2013.[17]

4 Improving the contribution of external audits to financial stability[18]

In March 2012, the FSB issued a public statement underscoring the importance of work to improve external audits by:

- enhancing the information provided to prudential supervisors and regulators of financial institutions, and
- reinforcing the effectiveness of the regulation of external audits, particularly those of financial institutions.

The financial crisis demonstrated the importance of addressing these issues. Work to improve audit practices and standards is ongoing, with some regulators and auditing

17 FSB Chairman's letter, "To G20 Finance Ministers and Central Bank Governors, Progress of Financial Regulatory Reforms", 16 April 2012. See www.financialstabilityboard.org/publications/r_120420a.pdf.

18 See press release at www.financialstabilityboard.org/press/pr_120315.pdf.

standard setters having issued finalized guidance on certain audit issues, and proposals in some other jurisdictions having been issued subject to public consultation. In view of the global nature of markets, financial institutions and audit firms, greater international consistency in external audit practices and requirements will be important while continuing to promote their high quality.

In particular, the FSB encouraged further work in the following areas:

1 *Improving the information that external audits provide to prudential supervisors and regulators of financial institutions, including systemically important financial institutions (SIFIs).* As part of this effort, the FSB will provide input to the BCBS' ongoing revision of its external audit policy papers and as it develops new robust external audit guidance, to be proposed by end-2012, and to the IAIS as it updates and enhances its policies with respect to external audits of insurance companies.

2 *Reinforcing the effectiveness of audit regulation, particularly for external audits of financial institutions, to improve audit quality.* The FSB is requesting IFIAR to report on (i) challenges and problems that its members have identified in their inspection programs relating to external audits of financial institutions, including audits of SIFIs; (ii) responses by IFIAR members to those issues, including follow-up with external audit firms; and (iii) member recommendations concerning steps that could be taken by audit regulators and auditors to further strengthen external audits of financial institutions. IFIAR decided at its Plenary meeting in April 2012 that it will seek to provide the report requested by the FSB by end-2012.

The FSB also announced that it recognizes the importance of other work underway to improve audit practices and standards and:

– encourages the continued efforts of the IAASB, internationally, and other audit standard setters in their national contexts to improve the standards on information that external audits provide to investors and other financial report users. The approaches set forth in various consultative documents differ across jurisdictions, and it will be important to seek high quality standards that enhance audit practices, and to the extent possible, improved international consistency. IOSCO has agreed to monitor developments in this area and provide updates to the FSB on progress.

– asks IOSCO to report to the FSB on authorities' experiences with the considerations in IOSCO's 2008 report on audit contingency planning.

– asks FSB members and other key bodies such as the IAASB, to provide input to the World Bank's review of how to enhance its Accounting and Auditing Reports on Standards and Codes (ROSCs).

The FSB will continue to support dialogue between audit standards setters and regulators, investors, market regulators, prudential authorities, financial institutions and audit firms on improving the quality of external audit and its contribution to financial stability.

5 Recent FSB efforts to further enhance risk disclosure practices

As previously mentioned, the importance to market confidence of useful disclosure by financial institutions of their risk exposures and risk management practices has been underscored in recent years. Building on the March 2011 FSB thematic peer review report and a roundtable held in December 2011, the FSB has undertaken an initiative to further enhance risk disclosure practices.

Consideration of whether enhanced risk disclosures are needed as new risk areas are identified

The FSB is following up on a recommendation in the FSB thematic review report, by considering on an ongoing basis whether there is a need for improved disclosures about new risk areas as these are identified. During 2012 the FSB will deepen these assessments, and will continue to draw on relevant expertise from the private sector in doing so. Efforts involving international standard setting bodies and joint private sector initiatives will in many cases be the most appropriate manner to take any new risk disclosure recommendations forward. The report recommended that the FSB should coordinate as necessary the alignment of the activities of standard setting bodies to fill any gaps arising because of a lack of a timely response or from financial stability concerns.

Summary of key themes that arose during the FSB roundtable on risk disclosure

In December 2011, the FSB hosted a roundtable on risk disclosures by financial institutions.[19] Eighty-two senior officials and other experts from around the world took part, representing investors and analysts, asset managers, credit rating agencies, banks, insurance companies, audit firms, audit regulators, accounting and auditing standard setters, as well as prudential and market authorities. The roundtable fostered a rich and lively dialogue about the current state of risks and related disclosures and how to improve their transparency. The key themes that arose during the course of the discussion are summarized below:

- *Risk disclosure foundations.* Participants generally preferred risk disclosure requirements in accounting standards and securities regulatory requirements that are principles-based rather than rules-based, but investors also called for measures to improve comparability, such as more consistent risk disclosure formats or templates. Principles-based approaches, such as those in the IASB's IFRS 7 (on financial instrument disclosure) and the US Securities and Exchange Commission's guidance on management's discussion and analysis (MD&A), may be sufficient to underpin disclosure improvements of the type discussed at the roundtable without the issuance of new disclosure requirements, but greater attention needs to be paid to address user needs for information about emerging risks.

- *Views of regulators and accounting standard setters.* The IASB and FASB discussed their initiatives in recent years to enhance risk disclosures. These include IASB improvements in standards for disclosures about financial instrument risks and valuations, and about off-balance sheet exposures, and FASB enhancements in standards for disclosures about credit risk, valuations and off-balance sheet risks. The two Boards have issued converged standards for improved disclosures about the gross and net exposures associated with derivatives and certain other financial instruments.

  Regulators generally acknowledged some recent improvements in risk disclosure practices but they shared the view that further improvement would be useful to enhance transparency. Securities regulators noted the benefits of

19 See press release and roundtable summary at www.financialstabilityboard.org/press/pr_120320.pdf.

regulators and firms reaching out to key stakeholders about disclosure issues and the importance of monitoring information discussed during senior management calls with analysts and the related presentations, which could provide insights into ways to improve financial report disclosures. They noted, however, that this required significant resources. The Financial Policy Committee of the Bank of England has encouraged improvements in the quality of disclosures as indicated the Bank's Financial Stability Reports in June and December 2011.

– *The role of auditors in risk disclosures.* External auditors are currently required to consider the risk of material misstatement of the financial statements in planning and performing the audit. Where the applicable accounting framework requires disclosure in the financial statements of information relating to risk, the auditor is required to audit that disclosure. The auditor's responsibility for disclosures in documents accompanying the financial statements – such as those in MD&A or the financial review section of financial reports – is generally limited to considering whether it is materially inconsistent with the audited financial statements or a material misstatement of fact. Auditors' roles are also limited with respect to disclosures in interim financial reports. Generally, other risk disclosures, such as those in presentations to investors and analysts or on a firm's websites, are not subject to external auditor's review.

  Audit regulators and standard setters summarized their recent guidance which included (i) alerts to auditors for assessing and responding to the risk of material financial statement misstatement in this difficult economic environment and (ii) consultative documents to explore possible improvements in auditor reporting and/or changes in the role of the external auditor for disclosures outside the financial statements (e.g., risk disclosures in MD&A). They are considering ways of expanding the scope of risk-related reporting responsibilities through consultative documents issued in 2011 and further work planned for 2012. Challenges remain in areas such as auditability of forward-looking statements, application of materiality concepts, and going concern assessments.

Investors and analysts stressed that disclosure that enhances the transparency of risks and risk management practices helps to build confidence in the firm's management, which can be particularly important to attract debt and equity investors. However, they argued that still many financial firms provide only minimal risk disclosures or obscure important information in voluminous disclosures that are not relevant or prioritized. Many participants encouraged that disclosure on past risks no longer of key importance should be allowed to be phased out, to ensure more relevant disclosure and avoid unnecessary reporting burden.

Enhancements discussed. Given the current financial market environment, participants expressed the view that enhanced qualitative and quantitative disclosure is particularly important in the following areas:

– *Information on governance and risk management strategies.* Investors requested better qualitative disclosures about governance, risk management oversight and related controls, and qualitative and quantitative disclosures about risk management practices, risk exposures and remuneration. Banking and insurance representatives noted the relevance of information about a financial institution's risk appetite and that risk disclosures would be most relevant if they were consistent with information used internally for risk management purposes. Disclosure should be put in the context of the financial institution's business model to facilitate market understanding of risk management practices.

- *Summary disclosure and benefits of achieving comparability.* Participants agreed that risk disclosure should be timely, clear, prioritized, consistent and comparable, as highlighted by a recent survey of financial report users. Many analysts recommended more use of executive summaries of the key risk categories, which should include key metrics on entity-wide risk exposure and risk management effectiveness. Disclosures should better differentiate market risk components (e.g., interest rate, foreign currency and commodity risk as separate disclosure categories) and firms should avoid voluminous or boilerplate disclosures presented as a compliance exercise. Some supported the idea of standardized common disclosure templates to facilitate comparability across firms and jurisdictions and to aid aggregation and assessment of system-wide risks. Others pointed out that risk disclosure should be supported by qualitative information that provides management's context for measurements and important firm-specific considerations.

- *Credit risk.* While acknowledging that some banks have enhanced their disclosures in recent interim reports, participants encouraged improved disclosure about exposures to sovereign debt and to other financial institutions. In addition to the areas for potential enhanced credit risk disclosure raised in the FSB Report, including the disclosure of renegotiated loans for troubled borrowers, participants discussed other areas where enhanced risk disclosure could be useful, such as: (i) expected credit losses for impaired financial assets, (ii) counterparty exposures, (iii) derivatives, (iv) off-balance sheet and joint venture structures, and (v) risk concentrations.

- *Liquidity risk.* Participants noted the importance of transparency about liquidity and funding risks, including potentially additional disclosures about sensitivity analyses, sources and volume of liquidity buffers, and maturity tables including contingent lending commitments. Given the increasing role of collateral, participants shared the view that the degree of asset encumbrance should be disclosed at a reasonable interim frequency as well as annually. Some mentioned the importance of addressing the liquidity of collateral and the extent of its use and residual availability.

- *Capital adequacy and risk weighted assets (RWAs).* Participants said that disclosures on capital planning (including the ability of firms to transfer capital across borders) were important. Further disclosure about RWAs and their calculation methods would be helpful. Investors noted as a positive development that some banks had started to disclose their regulatory leverage ratios voluntarily.

- *Pillar 3 disclosure.* Participants indicated that the usefulness of Pillar 3 disclosures was hampered by difficulties in reconciling the unaudited Pillar 3 information to the audited financial statements of firms. Participants generally supported more integrated presentation which would, for example, better link and allow navigation between the Pillar 3 and financial report (e.g., IFRS 7) risk disclosures, align the timing of their publication, and achieve more comparability across jurisdictions and banks. In addition, some noted as important that liquidity information was included in the Pillar 3 framework, as set forth in the Basel Committee's current plans.

– *Scenario and sensitivity analyses.* Some participants expressed their desire that the results of stress tests should be disclosed in financial reports, possibly with an indication as to whether the results are reviewed by external auditors. Care should be taken to properly interpret stress test results and summaries information in a manner useful to investors (e.g., using the impacts on earnings and capital of a certain change in interest rates, providing relevant information about non-linearity).

The roundtable showed the value of robust exchanges on shortcomings in disclosures among a wide range of private sector and public sector stakeholders. The full range of participants agreed that it would be important for investors, financial institutions and auditors to develop principles and formats for better risk disclosures going forward, with input from standard setters and regulators, as recommended in the FSB Report. Participants noted that these principles and leading practice disclosures should be broad in scope to avoid disclosure arbitrage among various market participants.

However, some felt that the private sector would not initially be able to carry forward this work on its own. Some called for more proactive involvement of the official sector under the current stressed situations where voluntary risk disclosure initiated by some in the private sector alone might not be sufficient to restore confidence quickly. Many expressed the view that the FSB should continue to help encourage and facilitate this work, perhaps by conducting another roundtable in 2012 and prompting a task force of investors, analysts, rating agencies, financial institutions, and auditors, with input from standard setters and regulators, to take forward this work.

FSB next steps in its risk disclosure initiative

Taking account of the views expressed at the December 2011 FSB roundtable and the recommendations set forth in a March 2011 FSB report on risk disclosures, the FSB announced in March 2012 the following next steps:

– The FSB will facilitate the formation of a task force to develop principles for improved disclosures based on current market conditions and risks, including ways to enhance the comparability of disclosures. The task force will involve investors, financial institutions, and external auditors and will be requested to develop proposed principles later this year for implementation in connection with end-year 2012 annual reports. The task force is expected to commence its activities in May 2012.

– The task force will be encouraged to have dialogue with standard-setting bodies, such as IOSCO, BCBS, IAIS, the IASB, the U.S. FASB and the IAASB, at key stages as it develops its recommendations and to report to the FSB.

– The FSB will also ask the task force to identify leading practice risk disclosures presented in annual reports for end-year 2011 based on broad risk areas such as those identified in the summary of the roundtable. The task force would be asked to report on these leading practice disclosures to the FSB in 2012.

- The FSB will consider holding another international roundtable in late 2012 to facilitate further discussion by investors, financial institutions, auditors, standard setters, regulators and supervisors on market conditions and risks at that time and the progress toward improving the transparency of risks and risk management through relevant disclosures.

As the March 2011 FSB report noted, should the follow-up actions by the private sector not result in sufficient progress in this area, the appropriate international standard-setting bodies will be asked to take forward work to consider principles.

In May 2012, the FSB announced that the new private sector task force – called the Enhanced Disclosure Task Force – has been established and the FSB public statement provided information about the co-chairs and other members of the task force. Mark Carney, Chairman, FSB, welcomed the formation of the Enhanced Disclosure Task Force. He added "The FSB supports these efforts which, together with the activities of standard setters, are expected to result in improved risk disclosure practices by financial institutions that will provide timely and useful information to investors."[20]

6 Conclusion

The FSB and its predecessor, the FSF, have encouraged improvements in the transparency of financial institutions and this article has summarized key initiatives in this respect, with a focus on those since 2008. These include calls for actions by market participants, standards setters, supervisors and regulators in a number of broad areas; namely:

- Convergence to improved standards by the IASB and FASB;
- Risk disclosure by market participants starting in 2008 about structured credit products, subprime exposures and SPEs;
- Off-balance sheet entities;
- Valuation;
- Transparency in securitization processes and markets;
- Enhanced external audit practices; and
- A joint private sector initiative to improve risk disclosure practices.

There has been a good deal of progress toward improved standards and practices. The FSB's thematic review of risk disclosure practices found that risk disclosure by financial institutions had improved following the FSF's 2008 recommendations. In addition, the IASB and FASB are making progress on projects to improve and converge their standards on financial instruments, including a joint expected loss impairment/provisioning approach and a more converged approach to classification and measurement. Important improvements to their standards on financial instruments, valuation, and off-balance sheet entities were finalised in 2011.

The more recent initiatives on external audit and joint private sector work on better risk disclosure principles and practices are aimed at further enhancements in practices beginning within the next year.

20 The FSB press release can be seen at www.financialstabilityboard.org/press/pr_120510.pdf.

Enhanced dialogue between regulators, standard setters and industry is very important. The FSB encourages such dialogue in a manner that respects the independence of the standard setting bodies. This dialogue with key stakeholders and respect for the independence of standard setters are critically important in achieving improved global standards and their sound, high quality implementation across jurisdictions and the financial services industry. The FSB will continue to encourage improved standards and practices and monitor progress as part of its initiatives to enhance transparency.