

Thematic Review

Measurement and transparency of bonds and other positions in countries with sovereign risk

Supervision of Financial Reporting

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The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

1 Summary and Conclusions

1.1 Conclusions

In their financial reporting 2011, listed financial institutions increased transparency of sovereign and non-sovereign debt exposures compared to 2010. Enhanced transparency in relation to these exposures is important to investors, in particular with regard to GIIPS countries (Greece, Italy, Ireland, Portugal and Spain). Measurement and recognition of sovereign debts in the financial reporting of financial institutions is in accordance with the financial reporting requirements. This is shown in the thematic review 'Measurement and transparency of bonds and other positions in countries with sovereign risk', which was carried out by the AFM on the financial reporting 2011.

The AFM sees room for further enhancing transparency of sovereign and non-sovereign debt exposures in the following respects (see paragraph 4.6 and 4.8):

- Disclosure of exposure to sovereign and non-sovereign debts; disclosure of the gross exposures, the nominal amount and the maturity analysis for the sovereign debt portfolio by GIIPS country, together with providing a reconciliation of the sovereign debt exposures by GIIPS country at the beginning and end of the financial reporting period (see paragraph 4.1);
- Impairment; the judgements made in determining whether or not to impair sovereign and non-sovereign debts(see paragraph 4.2);
- Measurement; disclosure related to measurement of sovereign debts (see paragraph 4.3);
- Hedging; disclosure of the extent to which credit default swaps mitigate credit risk of financial institutions (see paragraph 4.4).

In addition, the AFM would like to emphasize that it is important that (financial) institutions assess at every reporting period what information is relevant to be presented in the financial reporting to achieve a fair presentation and to enable investors to evaluate the nature and extent of risks arising from financial instruments to which the financial institutions are exposed, such as exposure to sovereign and non-sovereign debts. Market developments may require disclosures of sovereign and non-sovereign exposures of other (than GIIPS) countries as well.

A summary of the findings from this thematic review can be found below.

1.2 Summary

Currently, the sovereign debt crisis is an important topic for the financial reporting of institutions, in particular financial institutions. It is important that investors are aware of the nature and extent of risks arising from sovereign and non-sovereign debt exposures of financial institutions, in particular relating to GIIPS countries. Enhanced transparency on this matter, may help the financial sector to regain trust.

The conducted review relates to measurement, recognition and the disclosure of sovereign and non-sovereign debts. The review included ten Dutch listed financial institutions.

The AFM is required to carry out this thematic review on the basis of public information¹. That is why the AFM is unable to establish the background of a number of its findings. The AFM will further review the financial reporting of the institutions concerned and possibly approach them with a request for additional information.

Disclosure by financial institutions of their exposure to sovereign and non-sovereign debts

All ten reviewed financial institutions disclosed their net exposure to sovereign debts by GIIPS country as at 31 December 2011. This is an improvement compared to 31 December 2010, when only eight out of ten institutions provided this disclosure. The total net exposure to sovereign debts of GIIPS countries amounted to €11.2 billion as at 31 December 2011. All financial institutions also disclosed in which IAS 39 category² the net exposure to sovereign debts of GIIPS countries is classified. Furthermore, the AFM noted that all additional information on exposure to sovereign and non-sovereign debts in press releases or in presentations made to analysts was included in the financial reporting 2011 as well. This is positive and an improvement in relation to 2010.

Disclosure of the gross exposures, the nominal amount and the maturity analysis for the sovereign debt portfolio by GIIPS country, as well as a reconciliation between the sovereign debt portfolio by GIIPS country at the beginning and end of the financial reporting period, can be further improved. This information was not included in the financial reporting 2011 of almost all financial institutions.

A minority of financial institutions provided information about non-sovereign debt exposures. These institutions disclosed the nature and amount of these exposures by GIIPS country. These exposures related to corporate bonds of financial and non-financial institutions, mortgages and other types of consumer loans, as well as structured products (ABS, MBS,

¹ Based on Section 2(1) of the Financial Reporting Supervision Act (Wftv), the AFM can request further disclosure if, on the basis of publicly available facts or circumstances, it has doubts regarding the correct application of the reporting regulations.

² IAS 39-categories: financial assets at fair value through profit or loss, held-to-maturity, loans and receivables and financial assets available for sale.

RMBS, CMBS)³. The AFM expects that financial institutions include this information in their future financial reporting considering the importance of this information for users of the financial statements.

Impairment (Greek) sovereign debt

Seven financial institutions were exposed to Greek sovereign debt as at 31 December 2011. Six financial institutions impaired Greek sovereign debt in 2011. All these financial institutions had a computed impairment rate between 70 and 80 percent of the nominal value. One financial institution did not impair Greek sovereign debt. Although the net exposure of this financial institution to Greek sovereign debt was limited, the AFM does not understand why this financial institution did not impair Greek sovereign debt. One financial institution impaired loans granted to Greek public sector entities and guaranteed by the Greek government. These loans were also eligible for the Private Sector Initiative (PSI) (see paragraph 4.7) and were impaired using the same method as for Greek sovereign debt. These loans were impaired by 75 percent, in line with the impairment of Greek sovereign debt.

Only a minority of the financial institutions disclosed why other sovereign debt exposures were not impaired. Thus, there is room for improvement, in the view of the AFM.

Measurement sovereign debts

All impaired Greek sovereign debt was classified into the IAS 39 category 'available-for-sale'. In accordance with the requirements, the cumulative losses recognised in other comprehensive income with regard to Greek government bonds that were impaired were included in the profit or loss account.

Four financial institutions measured Greek sovereign debt on the basis of the market rates as at 30 June 2011 (level 1 valuation)⁴. Two financial institutions applied a level 2 valuation method for Greek sovereign debt or a mix of level 2 or level 3 valuation method as a result of a decreased liquidity of the Greek sovereign debt market. Both financial institutions specifically indicated that non-quoted market rates were used in this respect. Financial institutions did not disclose if models were used for the valuation, nor the assumptions applied. Therefore, there is room for improvement, according to the AFM.

Other findings

Five financial institutions explicitly disclosed the use of credit default swaps. The majority of the financial institutions only disclosed that these credit default swaps related to exposures to GIIPS countries as a whole. Credit default swap holdings (gross and net) were not disclosed by country. One financial institution disclosed the gross exposures for both buy and sell positions

³ ABS: Asset Backed Securities, RMBS: Residential Mortgage Backed Securities, MBS: Mortgage Backed Securities, CMBS: Commercial Mortgage Backed Securities

⁴ The fair value hierarchy consists of three levels that reflect the significance of the inputs used in making the measurement. Level 1 relates to quoted prices in active markets. Level 2 relates to valuation techniques using inputs based on observable market data. Level 3 relates to valuation techniques using inputs that are not based on observable market data.

of credit default swaps by GIIPS country. This enables users of the financial statements to assess, by country, to what extent credit risk is not hedged. This transparency enables users to evaluate to what extent financial institutions are exposed to sovereign debts by country. The AFM expects that other financial institutions will also include this disclosure in their future financial reporting.

The AFM listened to webcasts following the release by financial institutions of their annual results for the year ended 31 December 2011. These webcasts revealed relevant information, in particular as a result of questions asked by analysts. Among others, analysts asked the management board to what extent financial institutions were exposed to risks relating to GIIPS countries by financial instrument, counter party risk and the strategy of the financial institution regarding the exposures to risks relating to GIIPS countries. According to the AFM, this kind of disclosure, which is relevant for financial reporting, is important for users. In particular, this relates to information about the strategy of the financial institution regarding the exposure to risks relating to GIIPS and other countries. This can be further improved.

In 2011, one out of ten financial institutions reclassified, in accordance with the requirements, financial assets from the IAS 39 category 'available-for-sale' to the IAS 39 category 'held-to-maturity'. The reclassification accounted for 5.4 percent of the balance sheet total and related for 90 percent to Portuguese sovereign debt.

2 Introduction

By conducting a generic review of certain aspects of financial reporting, the AFM's intention is to raise awareness of important issues. In 2012, the AFM paid attention to the measurement of sovereign debts and the transparency of financial institutions about risks arising from sovereign and non-sovereign debt exposures. Non-sovereign debt exposures relate to the exposure to losses, caused by events in a particular country which are, at least to some extent, under the control of the government, but definitely not under the control of a private enterprise or individual.

Currently, the sovereign debt crisis is an important topic for the financial reporting of institutions, in particular financial institutions. It is important that investors are aware of the nature and extent of risks arising from sovereign and non-sovereign debt exposures of financial institutions, in particular relating to GIIPS countries. Enhanced transparency on this matter, may help the financial sector to regain trust.

Both the AFM and the European Securities and Markets Authority (ESMA) paid considerable attention to this subject. The AFM as well as ESMA carried out reviews on the accounting of sovereign debts in the semi-annual financial reporting 2011. Furthermore, on 28 July and 25 November 2011 ESMA issued statements on the accounting of sovereign debts, stressing the need for enhanced transparency and compliance with International Financial Reporting Standards (IFRS), in order to achieve consistent application and enforcement of financial reporting requirements by European countries. The Statement issued on 25 November 2011 contained two sections. One section discussed accounting issues relating to sovereign debts in the financial reporting 2011, the other section contained an opinion about the accounting for exposures to Greek sovereign debt in the semi-annual financial reporting 2011.

The European findings prompted the AFM to organise a roundtable meeting on 23 December 2011 with, among others, representatives of financial institutions, audit firms and investors. Investors indicated that it is of great importance that the financial reporting is transparent about gross and net (hedged) exposures of financial institutions to debts issued by both central and local governments, fair value measurement of sovereign debts and related impairment losses.

These events and recent sovereign debt developments have been reason to conduct a thematic review of the measurement and disclosures related to sovereign and non-sovereign debts for Dutch listed financial institutions.

3 Population, objectives and design of the thematic review

The AFM carried out a thematic review of the financial reporting 2011 of Dutch financial institutions, whose shares and/or debt securities were admitted to trading on Euronext Amsterdam as at 31 December 2011 and who had, based on public information, a significant exposure to sovereign or non-sovereign debts as at 31 December 2011. The review includes ten financial institutions, of which five insurance companies, three banks and two institutions with both insurance and banking activities.

This thematic review is intended to encourage (financial) institutions to enhance the quality and transparency of their financial reporting. The AFM's supervision further contributes to enhancing the public's understanding of financial reporting and thereby improving the functioning of the capital markets. The responsibility for the quality and transparency of the financial reporting of course rests primarily with the institutions themselves.

By means of conducting this thematic review the AFM intends to encourage the management board to enhance both quality and transparency of the financial reporting in relation to sovereign and non-sovereign debts.

In this thematic review, which paid particular attention to the exposure of financial institutions to risks arising from GIIPS countries, the AFM investigated the measurement and recognition of sovereign debts in the financial reporting 2011 of financial institutions. In addition, the AFM paid attention to the disclosure of sovereign debts in the financial reporting 2011 of these institutions and the degree of consistency between these institutions. The AFM also investigated the correct application of the financial reporting requirements on measurement, recognition and disclosure of sovereign debts (IAS 39 and IFRS 7). Furthermore, the AFM evaluated to what extent sovereign debt disclosures, provided by financial institutions in press releases, presentations made to analysts and web-casts, were also included in the financial reporting.

This review may serve as a point of reference for Dutch financial institutions and contribute to enhancing the public's understanding of financial reporting and thereby improving the functioning of the capital markets.

The general disclosure requirements in IFRS 7 are applicable to sovereign and non-sovereign debts. It is important that financial institutions disclose information that enables users of financial statements to evaluate the significance of financial instruments for its financial position and performance, together with the nature and extent of risks arising from financial instruments to which the financial institution is exposed.

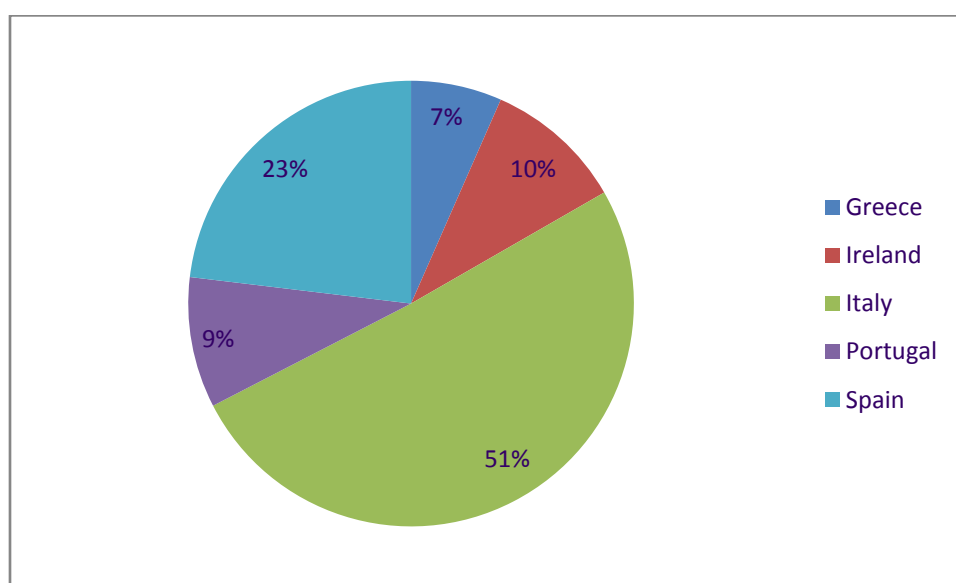
The disclosures which the AFM expects financial institutions to include in their financial reporting are based on the specific requirements of IFRS 7 as well as the general objective of IFRS 7. All disclosures described in chapter 4 of this thematic review are, according to the AFM, required on the basis of IFRS 7.

The AFM will ask financial institutions for additional information when it has doubts about the correct application of financial reporting standards in relation to measurement, recognition and disclosure of sovereign and non-sovereign debts.

4 Findings

4.1 Transparency of nature and amounts of sovereign debts by country has increased, but can be enhanced further

The following graph illustrates the net exposure to sovereign debts by GIIPS country of all ten financial institutions under review. The net exposure amounts to €11.2 billion as at 31 December 2011.



Graph 1: Net exposure to sovereign debts by GIIPS country as at 31 December 2011

All financial institutions disclosed their net exposure to sovereign debts by GIIPS country as at 31 December 2011. This is an improvement compared to 31 December 2010, when two financial institutions did not disclose the amounts and nature of the exposure to sovereign debts by GIIPS country. Therefore, the total net exposure of these financial institutions to sovereign debts by GIIPS country as at 31 December 2011 cannot be compared to the exposure as at 31 December 2010. In the roundtable meeting, which the AFM organised on 23 December 2011, investors indicated that it is important to know to what extent financial institutions are exposed to sovereign debts, in particular sovereign debts of GIIPS countries. Market developments may also require disclosure of exposure to sovereign debts of other countries. A limited number of financial institutions disclosed its total exposure to sovereign debts by country.

All financial institutions provided information about the classification by IAS 39 category of the net exposure to sovereign debts of GIIPS countries. This is an improvement compared to 2010, when only eight out of ten financial institutions provided this information.

All financial institutions disclosed the net exposure to sovereign debts by GIIPS country. However, only four financial institutions disclosed the gross exposures by GIIPS country. The majority of the financial institutions did not disclose the nominal amounts of the sovereign debt portfolio by GIIPS country. All financial institutions, except for one, did not provide a maturity analysis of the sovereign debt portfolio by GIIPS country.

Furthermore, only one financial institution provided a reconciliation of the exposure to sovereign debts by GIIPS country between 31 December 2010 and 31 December 2011. Such a reconciliation enables users to gain knowledge about the nature and amount of the exposure. After all, change in the exposure can be the result of changes in value, but also of buying and selling of sovereign debts, recycling of losses and hedging.

The AFM takes the view that these disclosures are important for investors. Therefore, it is important that financial institutions assess on a continuous basis what information should be disclosed in the financial statements. This enables users to better evaluate the nature and extent of risks relating to sovereign debts, such as sovereign debts of GIIPS countries.

4.2 Nearly all financial institutions impaired Greek government debt

Seven financial institutions were exposed to Greek government debt as at 31 December 2011. Six financial institutions concluded that there was objective evidence of impairment of Greek government debt as at 31 December 2011. Consequently, they incurred impairment losses. This is in accordance with the PSI dated 24 February 2012 (see paragraph 4.7). One financial institution did not impair Greek government debt. The financial institution considered the exposure to Greek sovereign debt to be not significant.

These six financial institutions computed an impairment rate between 70 and 80 percent of the nominal value.

One financial institution impaired loans granted to Greek public sector entities and guaranteed by the Greek government, because these loans were also eligible for the PSI (see paragraph 4.7). These loans were impaired using the same method as for Greek debt. These loans were impaired by 75 percent, in line with the impairment of Greek sovereign debt.

All financial institutions, except for one, did not incur impairment losses relating to sovereign debts of other countries. One financial institution impaired Portuguese sovereign debt. The exposure was not significant.

A majority of the financial institutions that impaired Greek sovereign debt, disclosed, in general terms, why they take the view that there was objective evidence of impairment of Greek debt as at 31 December 2011. Only a minority of the financial institutions disclosed why other sovereign debt exposures were not impaired. One financial institution provided an explanation by GIIPS country. The AFM takes the view that is important for users to include these disclosures in the financial statements, considering the current economic conditions.

4.3 Disclosure related to measurement of sovereign debts can be further improved

All impaired Greek sovereign debt was classified into the IAS 39 category 'available-for-sale'. In accordance with the requirements, the cumulative losses recognised in other comprehensive income with regard to Greek government bonds that were impaired were included in the profit or loss account. Four financial institutions measured Greek sovereign debt on the basis of the market rates as at 30 June 2011 (level 1 valuation). Two financial institutions applied a level 2 valuation method for Greek sovereign debt or a mix of level 2 or level 3 valuation method as a result of a decreased liquidity of the Greek sovereign debt market. Both financial institutions specifically indicated that non-quoted market rates were used in this respect. Financial institutions did not disclose if models were used for the valuation, nor the assumptions applied.

One financial institution measured sovereign debts of another country using a level 3 valuation. It related to parts of the Italian sovereign debt portfolio. The AFM takes the view that financial institutions, in order to determine the fair value of sovereign debts, have to consider whether the market for sovereign debts is active or not. If, and only if, a market is not active, a level 2 valuation method should be applied by using models based on observable market data for similar instruments. A level 3 valuation method should only be applied when reference to similar instruments is not possible. Only in rare cases this will be the case for sovereign debts.

Disclosure about the measurement of (Greek) sovereign debt is usually not provided in much detail. Financial institutions usually only disclose that the valuation is based on market prices, or, when a level 2 or level 3 valuation method is applied, this is caused by a lack of liquidity. There is considerable room for improvement.

4.4 Disclosure of the extent to which credit default swaps mitigate credit risk can be further improved

Five financial institutions disclosed the use of credit default swaps. In most cases, these financial institutions disclosed that the credit default swaps related to GIIPS countries, without providing the amounts (net and gross) of credit default swaps by country. Only one financial institution disclosed the gross exposures of both buy and sell positions of credit default swaps by GIIPS country. This enables users of financial statements to assess, by country, to what extent credit risk is not hedged. This transparency enables users to evaluate the net exposure of financial institutions to sovereign debts by country.

4.5 Financial institutions have hardly reclassified financial assets between IAS 39 categories in 2011

In 2011, one financial institution, in accordance with the requirements, reclassified financial assets from the IAS 39 category 'available-for-sale' to the IAS 39 category 'held-to-maturity'. The reclassification accounted for 5.4 percent of the balance sheet total. The financial institution did not specifically disclose the reason underlying the reclassification. The reclassification related for 90 percent to Portuguese sovereign debt. The Portuguese sovereign debt was

reclassified at its fair value on the date of reclassification. Any previous loss on Portuguese sovereign debt that was recognised in other comprehensive income will be amortised to profit or loss over the remaining life of the Portuguese sovereign debt. The impact on future financial results will most likely be limited, because this effect will be offset by the amortization of the difference between the new amortised cost of the Portuguese sovereign debt and the maturity amount over the remaining life of the Portuguese sovereign debt. The cumulative loss previously recognised in other comprehensive income will be recognised in the profit or account, if there is objective evidence that Portuguese sovereign debt is impaired.

There were no other financial institutions that reclassified financial assets between IAS 39 categories in 2011.

4.6 A minority of the financial institutions provided information on non-sovereign debt exposures

A minority of the financial institutions disclosed in the financial reporting 2011 to what extent they were exposed to risks arising from non-sovereign debts by GIIPS country. These institutions disclosed the nature and amounts of these exposures by GIIPS country. These exposures primarily related to corporate bonds of financial and non-financial institutions, mortgages and other types of consumer loans, as well as structured products (ABS, MBS, RMBS, CMBS). The amount of these exposures varied between some billions to more than €70 billion. In the latter case, more than half of the exposures related to one country.

Some financial institutions that disclosed the nature and amount of exposure to non-sovereign debts by GIIPS country also disclosed other information. One of these financial institutions disclosed into which IAS 39 category the exposures were classified, another financial institution disclosed the credit rating of the exposures. A third financial institution disclosed information about the real estate exposures and undrawn committed facilities.

The AFM takes the view that it is essential that investors are aware of the nature and extent of risks arising from non-sovereign debt exposures relating to GIIPS countries. If deemed necessary, this information should also be disclosed for other countries. Therefore, it is important that all financial institutions disclose their non-sovereign debt exposures by GIIPS country, in order for investors to evaluate to what extent and to which countries a financial institution is exposed to risks relating to non-sovereign debts. Currently, financial institutions do not always provide this information, although a number of these institutions appears to be exposed to these risks. Disclosure can therefore be enhanced.

4.7 Private Sector Initiative (PSI)

On 21 February 2012, Greece announced the key terms of a transaction, further to the 26 October 2012 Euro Summit Statement and its economic reform program, which has been agreed with the European Union and the International Monetary Fund. The full terms of the PSI were officially announced on 24 February 2012. The transaction involved an invitation to private

sector bondholders of certain Greek government debt to exchange their holdings with new bonds to be issued by Greece. The key terms of the PSI included the following provisions:

- 53.5 percent of the principal amount was forgiven by the private parties;
- 31.5 percent of the principal amount was exchanged into 20 new Greek government bonds with maturities of 11 to 30 years;
- the remaining 15 percent was provided in short-dated securities issued by the European Financial Stability Facility.

All financial institutions referred to the PSI in their financial reporting 2011. The financial statements of all ten financial institutions were published after the PSI was announced. Financial institutions often only disclose that the terms of the PSI announced on 24 February 2012 will be studied in more detail. None of the financial institutions provided details on the accounting treatment for the exchange of debt that occurred in 2012.

4.8 Disclosure of sovereign debts not included in the financial reporting

The AFM investigated to what extent financial institutions provided relevant information which was not included in the financial reporting 2011. In this regard, the AFM reviewed press releases and presentations, presentations to analysts or webcasts in relation to the financial reporting 2011. This revealed that none of the financial institutions provided additional information in press releases and presentations which was not included in the financial reporting 2011. This is an improvement compared to 2010. In 2010, some financial institutions disclosed information about their exposure to sovereign debts of GIIPS countries in presentations to analysts which were not included in the financial reporting.

Some webcasts contained relevant information, in particular as a result of inquiries by analysts. The analysts asked the management board to what extent financial institutions were exposed to risks relating to GIIPS countries, counterparty risk and the strategy of the financial institution regarding the exposures to risks relating to GIIPS countries. By definition, this information is relevant, because analysts are important users of the financial statements. The AFM takes the view that this information, which is relevant for financial reporting, is important for the view of investors.

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