2012-200 Comment Letter No. 67

JOSEPH STITUTE OF INTERNATIONAL FINANCE

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Re: Financial Instruments (Topic 825) – Disclosures about Liquidity Risk and Interest Rate Risk – <u>Liquidity Issues</u>

On behalf of the Senior Accounting Group and the Working Group on Liquidity of the Institute of International Finance (IIF), we appreciate the opportunity to comment on the Exposure Draft "Financial Instruments (Topic 825) – Disclosures about Liquidity Risk and Interest Rate Risk" issued by the Financial Accounting Standards Board on June 27, 2012.

This letter focuses only on liquidity issues, given their systemic importance and the need for cross-disciplinary consultations among liquidity and accounting practitioners. Interest-rate issues are addressed in a separate letter, dated September 21, 2012. Nevertheless many of our concerns are similar in both cases.

General Comments

We acknowledge that users of financial statements have legitimate interest in the liquidity issues set out in the Exposure Draft (ED) and that the ED notes at several points that users seek as much consistency and comparability as possible. Improving disclosure in these areas is important, but it is also important to emphasize that liquidity disclosure is in many ways different from other disclosures about financial institutions. It is also important, especially in this area, to make sure that the various new types of disclosures that are being mandated are coherent, do not undermine each other or other policy purposes, or provide a less than meaningful (or potentially confusing) source of data from a user perspective.

Equally important, it should be highlighted that liquidity disclosure has the potential, if misinterpreted, to cause or accelerate a run on a financial institution and may cause serious systemic disruption, with extensive but avoidable value-destruction. This is because liquidity risk has special disclosure characteristics not shared by other financial risks. Disclosures of other risks broadly do not change the nature of the risk itself; however, for liquidity risk, disclosures can have broad and grave micro prudential and macro prudential effects. Furthermore, the potential impact from disclosing other risks that may arise from misconstruing disclosed information are more manageable and likely to be only temporary once explained. However, this is not the case for liquidity risk. Once a liquidity event occurs, it is very difficult, if not impossible to reverse and too late for management to explain the company's liquidity position even if fundamentals prior to the liquidity event

were sound. The wrong kind of liquidity disclosure can also be highly pro-cyclical: the figures usually have high volatility especially if they are reported at discrete points of time (corresponding to the reporting date). This is more of a potential issue for liquidity than for other risks because of the short time fuses on which liquidity problems can develop and because on a relative basis it may be more difficult for end users to understand and use liquidity disclosures that are actually meaningful. Essentially, untimely or poorly understood liquidity disclosures could turn a relatively minor adverse development into a highly material or even catastrophic one, from both the micro prudential and the macro prudential points of view. It is because of the interaction of these firm-specific and systemic effects that caution is especially required

There is no easy answer to this dilemma, but the special nature of liquidity risk suggests that further, intensive discussions are required, and should involve all stakeholders, prudential regulators and ministries of finance. As a consequence, we suggest that the standard-setters should defer action on further liquidity disclosures until the Basel Committee has made recommendations on the subject and there has been time for public consultation on such recommendations.

Furthermore, the proposed requirements need to be refocused on the purpose of liquidity-risk disclosures, which presumably would be to present the general characteristics and resilience of a firm's liquidity positions. As discussed further herein, a firm's effective, economic liquidity position may be quite different from the mere statement of the terms of its assets and liabilities proposed.

Moreover, as discussed further below, it is more appropriate for forward-looking information to be disclosed through other means rather than through the audited part of the financial statements, for example the Management's Discussion and Analysis Section (in the US) or Pillar 3 etc. (It would often be appropriate to disclose risk information by cross reference from the financial statements to some other statements that are available to users at the same time.)

Given the number of significant discussions under way, it will be especially important to aim at international consistency around liquidity disclosure (with Basel III requirements and FSB provisions, as well as with IFRS7) in order to avoid confusion and the cost of providing recalculations between different reporting frameworks. As a result, the IIF recommends that the FASB defer finalizing the liquidity proposal in the ED until the disclosure-related projects that are currently being undertaken by the FASB itself and other bodies are completed, to benefit from their extensive public discussion.

Alignment with Disclosure Framework

Even though we believe that liquidity disclosure raises particular issues that require close attention and specific measures, we also think that final standards should be aligned insofar as possible with the pending discussions of the Disclosure Framework (comments due November 16 for FASB and December 31 for EFRAG) especially on materiality and relevance of the disclosures. This, therefore, reinforces the sense that the proposals in the ED should be delayed until (a) the special issues raised by liquidity disclosures have been

fully considered and appropriate measures to address them adopted across all frameworks (e.g. by mandating some time lag in publishing information about liquidity-risk management and issues that have arisen) and (b) final measures can be aligned with the disclosure framework.

Consistency with Liquidity-Risk Management and Basel III Requirements

Liquidity risk management is informed by many factors, including Basel III and local regulatory requirements and central-bank and payment system requirements.

Given the important qualitative elements of liquidity risk management and the differences in liquidity risk profiles that can exist among firms with different business models, any meaningful disclosure should start with information related to the firm's specific liquidity risk management policies, procedures, tactics and strategies, and not limited to the specific confines of the proposed quantitative disclosures. In turn, this qualitative information should be supported by quantitative disclosures that the firm finds relevant and useful not only in the context of these qualitative considerations but also in light of the regulatory and system requirements in its material currencies. Simplified "one size fits all" quantitative disclosure and the limited qualitative disclosures based on them would not be risk-based and may misinform users by inciting rote comparisons that would in fact not be informative of the true liquidity risk profile of the firm.

Liquidity disclosure should take into account the diversity of concerned firms, from small banks to international organizations. The prescriptive and detailed guidance included in the ED may be helpful for small organizations but not adequately present the true liquidity position and risk profile of a larger firm, without more relevant disclosure based on guidance that accommodates the circumstances and structures of larger firms.

As a general matter, the standard should allow firms to disclose liquidity metrics that are meaningful for the firm's business on a harmonized basis with Basel III, but also to disclose how their actual liquidity differs from prudential requirements where appropriate to reflect actual, available liquidity positions. Firms should have the right (and obligation) to augment disclosures to address deficiencies with regulatory metrics that would otherwise obscure the real liquidity position of firms, e.g., where prudential regulatory liquidity factors have high degrees of built-in conservatism or have been selected based on policy objectives, not observed market liquidity, historical behavior or expected exposures. For example, actually available liquid assets are highly likely to be greater than the categories of liquid assets defined as highly liquid for Basel liquidity buffers or other prudential purposes.

Therefore, we recommend that the FASB work with the Basel Committee and prudential regulators to ensure general consistency of definition of terms, subject to necessary adjustments to remove highly conservative treatments built into the regulatory requirements. As you are aware, the BCBS is still working to finalize the Basel III liquidity standard metrics. Once the substantive liquidity requirements are finalized, the BCBS will define the required disclosures surrounding these standards on both a qualitative and quantitative basis. Accounting disclosures prepared on a substantially different basis from Basel III would have the very real potential of confusing users since the "eyes of

management" view of liquidity in financial institutions will be strongly influenced by Basel III requirements.

For reasons of clarity and consistency and because of the special sensitivity of liquidity disclosures, new accounting requirements should be deferred until such disclosure requirements are finalized, and should be aligned with them insofar as is appropriate.

Consistency with IFRS

Given the importance of these issues to global investors in financial institutions in particular, it is very important to have consistency between U.S. GAAP and IFRS, to avoid confusion in the market, and possible divergences that could make comparability difficult. The intent is not to endorse the approach of IFRS7 as such, but to suggest that work toward consistency is required. Because the requirements represent a mix between accounting data and management data (undiscounted cash flows, contractual maturities, etc) the goal should be to maximize consistency, especially on a topic of such systemic sensitivity as liquidity.

Entity-Level Approach

The appropriate level of disclosure in the corporate group will vary depending on the group structure and the mode of its internal liquidity-risk management. For many, the most appropriate level of disclosure would be at the level of the consolidated group (including financial and non-financial institutions), subject of course to disclosure of limitations on transferability or fungibility arising from trapped liquidity at local levels (as contemplated by the proposal). Excessive reportable-segment level (See 825-10-50-23B) disclosure should be avoided as it would risk unnecessary complexity and density of disclosure without adding materially to useful information to users.

Audit Questions

The scope of audit of the proposed disclosures poses serious questions. While the Exposure Draft notes at page 4 the desire of users for audited and standardized disclosures, that demand must be balanced against the fact that, to be meaningful, augmented liquidityrisk disclosures must include both forward-looking and (as discussed further below) judgmental evaluation of historical experience and the behavioral characteristics of various market segments. Such information is inherently less auditable because the relevant amounts are not compatible with carrying amounts as requested in the ED. Indeed, to reconcile accounting data issued on a quarterly basis and data from liquidity gapping issued on a daily basis would be challenging, and it would create operational and audit difficulties.

Therefore, most of the proposed disclosures would be more appropriate in unaudited disclosure than as part of the financial statements.

Conclusions

We support global enhancement of disclosures and welcome the opportunity to comment. Nevertheless, we suggest that the Board take as much time as necessary to take

into account all the work in progress and align its final standards with other developments on liquidity-

- FASB's own work on the Disclosure Framework and forthcoming consultations
- FSB's final recommendations
- EFRAG's work on the Disclosure Framework
- Further developments on Basel III liquidity and liquidity-disclosure requirements.

In other words, we recommend:

- That the FASB defer finalizing the liquidity proposal in the ED until the disclosurerelated projects that are currently being undertaken by the FASB itself (i.e. the Disclosure Framework project) and other bodies are completed, to benefit from their extensive public discussion; and
- That for any disclosures provided in the audited financial statements (including in the footnotes), the FASB work with the Basel Committee and prudential regulators to ensure general consistency of definition of terms, tables etc.

It will also be important to foster the "eye-of- management" approach to liquidity disclosures, subject to providing users with necessary explanations to allow them to understand the "true" liquidity position of a firm, rather than contractual analysis that is likely to be less than fully relevant for liquidity purposes.

We stand ready to answer any questions on these matters and would welcome the opportunity to discuss them. If you have any questions, do not hesitate to contact the undersigned or Veronique Mathaud (vmathaud@iif.com; +1 202 682 7456).

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Yours faithfully,

Attachment

Appendix: Specific Comments

Summary and Questions for Respondents: "How do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?"

As a general matter, there is no reason for deviation between U.S. GAAP and IFRS on maturities or time intervals. The IFRS7 approach of allowing an entity to use its own judgment to determine the appropriate time intervals would be appropriate, given that regulatory requirements and market expectations will in any case lead to convergence of firms' decisions on time intervals.

Question 1 and 825-10-50-23E Expected Maturity

The "Summary and Questions for Respondents" stresses that "expected maturity refers to the expected settlement of the instrument resulting from contractual terms (for example, call dates, put dates, maturity dates, and prepayment expectations)." However, basing "expected maturity" on contractual terms poses serious difficulties and may result in fundamental misapprehension of a firm's liquidity position. This issue raises the fundamental question of the purpose of the proposed disclosures.

The term *expected maturity* as defined here refers to contractual terms. This seems to overlook the important behavioral issues that determine the performance of products such as deposits. Contractual information may be seriously misleading outside of a context of understanding information based on behavioral expectations (such information seems to be contemplated by 825-10-50-13J, *additional information necessary to understand exposure to liquidity risk*; however, presenting the most important characteristics of such liabilities (and products such as lines) as "additional information" may not be sufficient to mitigate the misleading nature of a quantitative expected maturity disclosure based purely on contractual terms). Similarly, Basis for Conclusions BC33 indicates recognition of the distinction between expected and contractual maturities but that recognition does not seem to have been translated into the definition of expected maturities in a way that would make the definition truly useful for understanding the liquidity position of the firm (as opposed to understanding the contractual terms of a portfolio of assets or liabilities). Similarly, 825-10-55-5F seems to overlook behavioral issues in presenting time deposits.

Contractual maturities are in fact only relevant for some types of assets and liabilities and would not give sufficient information to allow users to understand the managed liquidity position of the firm. Contractual maturities are perhaps easier to disclose and audit, but often of only marginal relevance for understanding the liquidity position of a firm. Firms manage their liquidity based on modeling their expectations for liquidity mismatches using a variety of business conditions. This is in no way captured by the tabular information required in the proposed standard. Thus users of the financial statements would still be left to make assumptions. Further, the tabular presentation turns what is actually a dynamic

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¹ Exposure Draft, Pg 2

process of managing liquidity into a static picture that is not useful for decision-making purposes.

Moreover, presenting liquid investment securities held in an AFS liquidity portfolio in contractual maturity buckets does not represent their "time to funding" given the ability to repo or sell such securities at any time (an important point for Basel liquidity buffer purposes). Similar issues arise with repos and reverse repos and the implicit risk of allowing certain funding relationships to terminate contractually.

On the other hand, disclosure of expected maturities on the basis of behavioral analysis requires discussion of internal assumptions and approaches and would not be fully comparable across firms. Disclosure of behavioral information, in addition to relying on modeling and management judgment, could also disclose sensitive business information, if it were too granular.

There is thus a dilemma between the two types of disclosures that needs to be worked out from a policy as well as an accounting point of view. The present draft does not adequately recognize the dilemma and thus needs more elaboration and debate before a solution can be found.

Once again, it would therefore be appropriate for the FASB to wait for the Basel Committee to complete its deliberations on appropriate liquidity disclosures, and then define congruent accounting standards, with appropriate adjustments to recognize the degree of conservatism that the Basel Committee will build in to any of its standards. Moreover the FSB is also working on disclosures in this area and, while it is too early to tell whether the industry would recommend following the FSB's recommendations for risk disclosures in an accounting context, it certainly makes sense to wait until that process as well as the Basel process is completed before taking any final decisions of any sort on liquidity disclosures.

Question 1 and 825-10-50-23F: Disclosure of Off-balance Sheet Commitments

Off-balance sheet items such as commitments provided to customers do not all have the same risk from a liquidity point of view. Clarification will be necessary. It would be helpful for users to have details about the nature of (committed, advised but uncommitted, undrawn etc.) and the way the liquidity manager evaluates them in the firm's liquidity position.

825-10-50-23T/825-10-50-23V: Available Liquid Assets

23T has a highly conclusory definition of unencumbered cash and high-quality liquid assets. That latitude is appropriate if it permits a firm to disclose its own assessment of what would constitute highly liquid assets, provided an explanation of the firm's assessment is added.

Assets assessed as available liquid assets may legitimately be different from one bank to another depending on the risk management and the capability of the entity to trade relevant instruments in wide markets.

825-10-55-5A: Example 4: Liquidity Gap Maturity Analysis for a Bank

In order to include derivatives in the table, the following problems have to be solved on a consistent basis.

- A derivative that is fully cash-collateralized would not have any cash exchanged upon settlement or at maturity, subject only to timing differences.
- If an option is non-collateralized, it is unclear whether the disclosed amount should be the full amount due or the expected cash-flow based on delta hedging. The latter is more likely accurately to reflect the liquidity position of a firm.
- For options, the contingent cash-flow would be difficult to extrapolate, and it has to be assumed that the fair value reporting is sufficient.
- It is not clear whether derivatives would be presented net or gross; net presentation would seem most useful to users in understanding the firm's liquidity position and better reconcile with the balance sheet. However, net presentation of cash flows will be difficult since the netting is not allocated to the individual contract level but is applied at the counterparty level. This information is not readily available in most firms' accounting systems. If it is gross then it could be different from the carrying amount.

Because of the issues identified above, and to be consistent with the disclosure requirements applicable to other components of trading portfolios, derivatives should be included only in the last summation column in the liquidity table, or excluded as are similar items that generate cash flow (such as interest or fees) because they do not represent principal cash-flow.

Question 5 and 825-10-55-5C Time Buckets for Maturity Gap Analysis

We think allowing an entity to use its own judgment to determine the appropriate time intervals would be appropriate, given that regulatory requirements and market expectations will in any case lead to convergence of firms' decisions on time intervals.

The table includes too many periods, especially interim periods. A framework to monitor and measure short-term liquidity and structural liquidity should include 30 days and additional buckets appropriate for the firm's business, such as 90 days, 100 days, one year and over one year. Beyond year two, the information becomes less meaningful as many variables are inevitably subject to change.

Remaining Questions for Preparers and Auditors – Liquidity Risk

Most questions are covered by the discussion above. The following specific comments should also be noted.

Question 1: Does the liquidity gap table for financial institutions including expected maturities of financial assets and financial liabilities pose operational concerns or constraints?

Major Management Information System challenges should be expected especially given the extent of additional information that would have to be auditable and the numerous differences from regulatory metrics. The demands on firms' time and human resources for IT changes are not trivial and must be aligned with the numerous other regulatory and accounting changes firms are going through; therefore, ample time should be allowed for developments, and it would make sense to allow changes for these purposes to be done in parallel with changes to be done for prudential-regulatory and risk-disclosure purposes: even if there are differences in some respects between the different purposes, they are all covering essentially the same economic data and risks and therefore development programs should logically be aligned.

Question 2: Does the cash flow obligations table for non-financial institutions, including expected maturities of an entity's obligations, pose operational concerns or constraints?

These comments are in addition to previous comments regarding aligning liquidity disclosures with regulatory requirements and the way liquidity is risk managed.

The usefulness of the non-financial institution cash flow obligation disclosure, particularly for derivative liabilities, is highly questionable, given that it provides only a gross view of cash flow obligations, and does not take into account collateral arrangements, economic hedges and the overall fact that not all cash flow obligations represent a draw on liquidity. Disclosing cash flows for certain derivative types, such as interest rate swaps, poses further challenges. For example, even when an interest rate swap is in a liability position, in certain periods presented, an entity may expect cash inflows as opposed to cash outflows. Further, the value of a derivative contract is affected by many variables including non-performance risk of the entity and its counterparty. For all these reasons, presentation of undiscounted cash flows related to derivative instruments by period would not be meaningful to users of financial statements, and could in fact be misleading.

There would be significant Management Information System challenges in preparing the required information for instruments carried at fair value, particularly for derivatives and structured notes with embedded derivatives, as this information is not generally available in current accounting systems and is not used for risk management purposes. Furthermore, systems do not exist to allocate counterparty or collateral netting to the individual derivative liability positions or to specific time intervals within the contract in order to calculate expected cash flows net of collateral across the specified time intervals.

Question 4: Quantiative disclosure of available liquid assets: do you foresee substantial operational concerns or constraints?

As just noted, the differences between the proposals and other types of liquidity-risk IT developments required will in themselves impose burdens. This problem is increased with the distance between the required disclosures and internal risk management. The behavioral and judgmental issues discussed above also need to be taken into account.