In case of discrepancies between the French and the English text, the French text shall prevail

Luxembourg, 11 July 2001

To all Luxembourg credit institutions

CIRCULAR CSSF 01/32

Re: **Disclosure of information on financial instruments**

Ladies and Gentlemen,

1. We are pleased to draw your attention to the adoption of Commission Recommendation *2000/408/EC* of 23 June 2000 concerning disclosure of information on financial instruments and other items complementing the disclosure required according to Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions. The aforementioned directive was transposed into Luxembourg legislation through the law of 17 June 1992 relating to the annual and consolidated accounts of credit institutions incorporated under Luxembourg law, as amended, and specified in the *Recueil des Instructions aux Banques*.

2. This circular implements the principles of the above-mentioned recommendation pursuant to Article 43 (3) of the law of 5 April 1993 on the financial sector, as amended, which sets out that the Commission de Surveillance du Secteur Financier shall ensure the implementation of EU law applicable to the area falling within the scope of its powers. This implementation is also the result of the international development as regards the disclosure of information. In this context, attention should also be drawn to the rules that the Basel Committee on Banking Supervision proposes to establish under the third pillar of the new framework on capital adequacy, as well as to the strategy of the European Commission to introduce IAS accounting standards on a European level which will result in requirements for the disclosure of additional information.

3. The purpose of this circular is to specify the additional information on financial instruments, such as defined in point II.2 below, that the credit institutions shall publish in the

notes to the accounts or in the management report. It should be borne in mind that the purpose of this circular is not to amend the accounting treatment (initial recognition and subsequent measurement) of the financial instruments in the balance sheet, off-balance sheet and profit and loss account. The financial instruments will still be governed by the accounting and valuation rules as defined in the above-mentioned law of 17 June 1992, as amended.

I. Introduction

4. Since the adoption of Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions, transactions on financial instruments substantially expanded, particularly regarding derivatives.

5. In parallel, banks and other undertakings are increasingly called upon on international level to provide enhanced disclosure of their activities in financial instruments. Furthermore, an enhanced disclosure of additional information complementing the limited disclosure required under the above-mentioned directive was considered necessary.

6. Disclosure of such information allows investors and market participants to take well-informed decisions, thus fostering market transparency and market discipline as a complement to prudential supervision.

7. To this effect, meaningful and comparable qualitative and quantitative information on institutions' activities relating to financial instruments and information on the objectives and methods of risk measurement and management systems is necessary.

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

9. Given the ongoing international discussions on the methods for disclosing such information a formal amendment of Directive 86/635/EEC introducing mandatory disclosure requirements appears to be premature. Consequently, the European Commission has chosen to publish a recommendation at this stage.

10. Insofar as it is necessary for the smooth functioning of the internal market that the accounting information published by banks and other financial institutions remains sufficiently comparable, the European Commission will closely follow the effect of this recommendation on current practice in the Member States and will later, if necessary, propose further actions to ensure sufficient harmonisation in this field.

II. General information

1. Scope

11. This circular applies to the management report and the notes to annual and consolidated accounts to be drawn up by credit institutions incorporated under Luxembourg law for the purpose of legal publication.

2. Definitions

12. The circular applies to **financial instruments**, no matter whether they are part of the trading portfolio or not.

13. For the purposes of this circular, **financial instrument** means any contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party.

14. According to the provisions laid down in IAS 32, the commodity-based contracts that give either contracting party the right to settle in cash or some other financial instrument shall be considered to be financial instruments, except those which

i) were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the company's expected purchase, sale or usage requirements;

ii) were designated for such purpose at their inception; and

iii) shall be settled at the delivery time.

15. Financial instruments include both:

- *primary* financial instruments, such as cash, receivables, payables, shares and other equities; and
- *derivative* financial instruments, such as options, futures, forwards, interest rate swaps and currency swaps, the value of which is derived from the price of an underlying financial instrument or a rate or an index or the price of an underlying other item and credit derivatives.

16. In this context, a distinction shall be made between financial assets and financial liabilities.

Financial assets include the following elements**:**

- Cash:

  mainly cash in hand, balances with central banks and post office banks.

- Elements representing a contractual right to receive cash or another financial asset from another party:

mainly treasury bills and other bills eligible for refinancing with the central banks, loans and advances resulting from leasing transactions, loans and advances to credit institutions, loans and advances to customers, debt securities and other fixed-income securities.

- Elements representing a contractual right to exchange instruments with another party under conditions that are potentially favourable:

  mainly forward purchases and sales of assets, transactions linked to exchange rates, interest rates and other market prices (whether they are traded on an OTC market or on a recognised regulated market).

- Equity instruments of another party[1]:

  mainly equity and other variable-yield securities.

Financial liabilities include the following elements**:**

- Elements representing a contractual obligation to deliver cash or another financial asset to another party:

  mainly amounts owed to credit institutions, amounts owed to customers, debts evidenced by certificates, subordinated liabilities, contingent liabilities, confirmed undrawn confirmed credit lines, debt securities issue facilities.

- Elements representing a contractual obligation to exchange instruments with another party under conditions that are potentially unfavourable:

  mainly forward purchases and sales of assets, transactions linked to exchange rates, interest rates and other market prices (whether they are traded on an OTC market or on a recognised regulated market).

It should be borne in mind that this distinction between financial assets and financial liabilities covers elements recognised in the balance sheet and elements recognised in the off-balance sheet.

17. According to this circular, the following items are not concerned by the disclosure requirements:

- Interests in subsidiaries and other affiliated undertakings.
- Interests in joint ventures and associates as set out in Article 102 respectively 103 (1) of the law of 17 June 1992 on the annual and consolidated accounts, as amended.
- Employers' plans and obligations for post-employment benefits of all types, including retirement benefits.
- Employers' obligations under employee stock option and stock purchase plans.

[1] An equity instrument is any contract that evidences a residual interest in the assets of a party after deducting all of its liabilities.

- Obligations arising under insurance contracts.
- Operating leases; take or pay contracts.
- Own equity, own warrants and options on own shares.

III. Information for disclosure

1. General Principles

18. For the purposes of disclosure a distinction should be made between two types of information, i.e. qualitative and quantitative information.

19. Information which has to be submitted for the purposes of this circular may be prepared based on the long-form report drawn up in accordance with Circular CSSF 01/27, on the periodic prudential tables, on the internal information system and management control as well as on other internal reports used by credit institutions.

20. Hereafter, the circular provides general instructions regarding information to be disclosed by credit institutions and an annexe with illustrative examples on the manner in which this information may be submitted.

21. Other presentations based, for example, on internal models may be used insofar as the bases of these models are indicated, the reliability of the information which is derived from it is evidenced and it is specified whether or not they were authorised by the Commission de Surveillance du Secteur Financier to calculate prudential capital requirements.

22. Where disclosure of quantitative information draws on institutions' internal risk management systems and the methods used within those systems (such as sensitivity analysis and VAR models) it is not necessary for the disclosure to be such as to disseminate information relating to those systems and methods that could be seriously prejudicial to the institution.

23. Furthermore, it is recommended that complementary information (on, for example, the terminology and the presentation forms used, on risk measurement methods, related assumptions and, where appropriate, other parameters) are provided where they are likely to allow readers of financial statements to better understand the quantitative information supplied.

24. Insofar as the year-end figures are not representative of activity levels, average values can further assist understanding. Where average values are disclosed, it is recommended that the institutions also provide indications on the intervals used to calculate those averages.

2. Qualitative disclosure

25. Qualitative information to be disclosed by credit institutions in the *notes* to the accounts respectively in the *management report* is listed below. Where other information is provided, it shall be indicated in the *notes* to the accounts, insofar as it is necessary for the understanding

of the accounts. If this is not the case, the credit institutions may choose to include this information either in the *notes* or in the *management report* whichever they deem more appropriate.

Objectives and strategies regarding risk management

26. Information shall be disclosed in the *management report* on the institution's risk management objectives and strategies reflecting its use of instruments within the context of its overall business objectives.

Policy and practices regarding risk management

27. Information shall also be disclosed in the *management report* on the policies and practice of managing the risks associated with trading and non-trading activities addressing the specific nature of the institution's exposure to, and its management of, credit risk, market risk (i.e. foreign exchange risk, interest rate risk, risk linked to price changes of equities and other price risks), liquidity risk and other risks of significance.

Applied accounting policies

28. Pursuant to Article 68 (1) of the law of 17 June 1992 on the annual accounts and consolidated accounts, as amended, information shall be disclosed in the *notes* to the accounts on all significant accounting policies related to different items of the annual accounts, including financial instruments.

3. Quantitative disclosure

29. Quantitative information to be disclosed by credit institutions is listed below. Quantitative information necessary for the understanding of accounts shall be disclosed in institutions' *notes* to the accounts. Other quantitative information shall be included in the *management report*.

Analysis of the financial instruments

30. Appropriate analysis shall be provided of trading and non-trading instruments, including information on the level of activity in the institution with respect to those instruments. The analysis reflects in particular significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

31. The fair values of instruments held for trading, both on and off the balance sheet, shall be disclosed where they materially differ from the amounts at which they are included in the accounts.

32. Fair value is the amount at which an asset could be exchanged or a liability settled in a current transaction entered into under normal terms and conditions between independent, informed and willing parties, other than in a forced or liquidation sale.

Credit risk disclosure

33. Information on credit risk exposure of trading or non-trading instruments shall be disclosed based on the amount that best represents the maximum credit risk exposure at the

balance sheet date (net of value or provision adjustments as well as of netting agreements that are legally enforceable by the institution) without taking account of any collateral. Information on the maximum credit risk exposure shall be complemented by information on the potential credit risk exposure taking into account collateral and other netting agreements.

34. If the carrying amount of an instrument already reflects the maximum credit risk exposure, disclosure of additional information other than the carrying amount, for the purposes of this paragraph, is not necessary.

35. With respect to OTC (not exchange traded) derivative instruments, the notional amount does not represent the maximum credit risk exposure. The maximum credit risk exposure is assessed by defining the *overall replacement cost*[2].

36. Information shall also be disclosed on significant concentrations of credit risk from financial instruments (on- and off-balance-sheet exposures) by economic sector and geographic location (for example by different industry sectors, individual countries or groups of countries).

Market risk disclosure

37. Information on market risk of trading or non-trading financial instruments shall be disclosed on the basis of value-at-risk, sensitivity analysis or any other measure allowing the identification of market price risk.

38. The different methods shall be used alternatively or in combination in such a way as to provide a comprehensive picture of the institution's exposure to market risks inherent in its positions in trading and non-trading instruments. Where applicable, separate disclosures shall be provided for each type of market risk.

IV. Materiality principle

39. The provisions of this circular are not to be applied to items which are deemed immaterial for the understanding of the accounts. In deciding whether instruments (either individually or in aggregate) are material, both the amount and the nature of the instruments shall be taken in to account.

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

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

[2] The overall/global replacement cost shall be calculated on the basis of the market risk method, in accordance with the provisions of point 12.5.a) and b) of part VIII of Circular CSSF 2000/10, i.e. by calculating the current replacement cost and, in addition, taking into account the potential future credit risk exposure (add-on). Institutions calculating the credit risk of OTC derivative instruments on the basis of the *original risk* method

42. Thus, the credit institutions which, pursuant to Circular CSSF 2000/10, are exempted from calculating the integrated ratio considering the reduced size of their trading portfolio do not need to provide information on trading financial instruments.

V. Entry into force of this circular

43. Information referred to in this circular shall be provided for the first time in the management report and in the notes to the accounts of the financial year starting on 1 January 2001 or after this date.

Yours faithfully,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

Arthur PHILIPPE Directeur	Jean-Nicolas SCHAUS Directeur général

Annexes

may disclose only the risk equivalent value obtained by applying the said method, in accordance with the provisions of point 12.6.a) of part VIII of Circular CSSF 2000/10.

Annexe 1

This Annexe provides illustrative examples of the manner in which certain information required in Chapter III of this circular may be produced.

It should be borne in mind that, in accordance with paragraph 19, information may be prepared based on the long-form report drawn up in accordance with Circular CSSF 01/27, on the periodic prudential tables, on the internal information and management control system as well as on other internal reports used by credit institutions.

I. Information in relation to qualitative disclosure

Risk management

Information to be provided in this context may cover:

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

II. Disclosure of quantitative information

1. Analysis of financial instruments

The main purpose of this analysis is to provide information on the level of activities in financial instruments of the institution concerned. This information may be disclosed in tabular form, as follows:

Information on primary instruments

Data on the level of activity of the institution concerned with respect to primary instruments on the **carrying amount** (cf. table I.1. in Annexe 2):

- broken down on the vertical axis into the different classes of instruments distinguishing between assets and liabilities, and
- broken down on the horizontal axis into residual maturities,

with additional indication of **fair value** of trading totals (cf. table I.2. in Annexe 2).

Information on derivative instruments

Data on the level of activity of the institution concerned with respect to derivative instruments on the **notional amount** (cf. table I.3. in Annexe 2):

- broken down on the vertical axis into different classes of derivative instruments (e.g. interest rate, foreign exchange and gold, equities, precious metals except gold, other commodities, credit derivatives, other), further subdivided into:

  - OTC derivative instruments (with sub-categories e.g. forwards, swaps, options purchased/written), and

  - exchange traded derivative instruments (with as subcategories e.g. futures long/short, swaps, options purchased/written); and

- broken down on the horizontal axis into residual maturities;

with additional indication of **fair value** of trading totals (cf. table I.4. and I.5. in Annexe 2).

Breakdown per residual maturity

As regards primary instruments and derivative instruments, time bands that are relevant for the information disclosed may be used, for example: not more than three months, more than three but not more than six months, more than six months but not more than one year, more than one year but not more than five years, more than five years.

Subject to materiality, the time bands specified may be further broken down (e.g. from zero to one month; from one to three months) or merged to larger time bands (e.g. from zero to one year; from one to five years; more than five years) as appropriate.

Information in terms of fair value of instruments held for trading purposes

The institutions may provide information, disclosed in tabular form distinguishing between assets and liabilities, indicating, *inter alia*, the level of activity in terms of **fair value** as opposed to the **carrying amount**:

- on carrying amounts and fair values of classes of trading instruments, and
- for trading instruments, on average-of-period fair values (cf. examples I.4. and I.5. in Annexe 2), and:

if the determination of fair value is not possible, practicable or reliable, additional information on the principal characteristics of the instrument that may affect its fair value.

2. Credit risk disclosure (cf. table II in annexe)

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

- broken down on the vertical axis into different degrees of credit worthiness of counterparties assessed on the basis of internal or external ratings; and

- broken down on the horizontal axis into:
  - notional amounts, net of the effects of enforceable netting agreements,
  - current replacement costs, net of the effects of enforceable netting agreements,
  - potential future replacement costs, net of the effects of enforceable netting agreements,
  - global replacement costs, net of any value adjustments/provisions,
  - risk exposures net of any collateral held as security.

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

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

3. Market risk disclosure

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

<u>Value-at-risk information</u>

<u>The potential effects on future earnings of selected hypothetical changes in market prices and rates</u>

The hypothetical changes used should be reasonably possible during the 12 months following the date on which the accounts are approved. One of these hypothetical changes might usefully include an adverse change of at least 10% in the year-end market prices or rates (unless such a change may be demonstrated not to be reasonably possible).

<u>A market price measure, other than those covered by the two previous points, provided that:</u>

- the institution's management uses the model from which the measure has been derived for the purposes of managing the market price risk arising from the use of trading instruments; and
- the model has been recognised for the purpose of providing capital adequacy returns to the prudential regulator.

<u>An analysis of the aggregate fair values of trading instruments held for trading purposes</u>

An analysis of the aggregate fair values by major categories of financial assets and financial liabilities arising from trading instruments and, within those categories, by time bands according to the earlier of the period to the next interest rate repricing or the maturity date.

Time bands that are relevant for the information disclosed may be used, for example: not more than three months, more than three but not more than six months, more than six months but not more than one year, more than one year but not more than five years, more than five years.

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

Annexe 2

This annexe provides additional examples in tabular form.

Example I.1. Analysis of financial instruments – Primary financial instruments not held for trading

Primary financial instruments not held for trading (in carrying amount)					
	<= 3 months	> 3 months <= 1 year	> 1 year <= 5years	> 5 years	Total
Categories of instruments (financial assets)					
...					
...					
...					
...					
...					
				Total	
Categories of instruments (financial liabilities)					
...					
...					
...					
...					
...					
...					
				Total	

Example 1.2. Analysis of financial instruments - Primary financial instruments held for trading

Primary financial instruments held for trading																
	<= 3 months			> 3 months <= 1 year			>1 year <= 5 years			> 5 years			Total			
	Acc. v.	Fair v.		Acc. v.	Fair v.		Acc. v.	Fair v.		Acc. v.	Fair v.		Acc. v.	Fair v.		
		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year	
Categories of instruments (financial assets)																
...																
...																
...																
...																
...																
												Total				
Categories of instruments (financial liabilities)																
...																
...																
...																
...																
...																
...																
												Total				

Example I.3. Analysis of financial instruments - Derivative instruments not held for trading

Derivative instruments (not held for trading)						(in notional value)						
OTC							Stock exchange					
	<= 3 months	> 3 months <= 1 year	>1 year <= 5 years	> 5 years	Total			<= 3 months	> 3 months <= 1 year	>1 year <= 5 years	> 5 years	Total
Categories of instruments (financial assets)							Categories of instruments (financial assets)					
Interest-rate instruments							Interest-rate instruments					
Forwards							Futures					
Swaps							Swaps					
Options							Options					
…							…					
Currency/gold instruments							Currency/gold instruments					
Forwards							Futures					
Swaps							Swaps					
Options							Options					
…							…					
Equity instruments							Equity instruments					
Forwards							Futures					
Swaps							Swaps					
Options							Options					
…							…					
Credit derivatives							Credit derivatives					
…							…					
				Total							Total	
Categories of instruments (financial liabilities)							Categories of instruments (financial liabilities)					
Interest-rate instruments							Interest-rate instruments					
Forwards							Futures					
Swaps							Swaps					
Options							Options					
…							…					
Currency/gold instruments							Currency/gold instruments					
Forwards							Futures					
Swaps							Swaps					
Options							Options					
…							…					
Equity instruments							Equity instruments					
Forwards							Futures					
Swaps							Swaps					
Options							Options					
…							…					
Credit derivatives							Credit derivatives					
…							…					
				Total							Total	

Example I.4. Analysis of financial instruments - OTC derivative instruments held for trading

Derivative instruments held for trading															
OTC	<= 3 months			> 3 months <= 1 year			>1 year <= 5 years			> 5 years			Total		
	Not. v.	Fair v.		Not. v.	Fair v.		Not. v.	Fair v.		Not. v.	Fair v.		Not. v.	Fair v.	
		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year
Categories of instruments (financial assets)															
Interest-rate instruments															
Forwards															
Swaps															
Options															
…															
Currency/gold instruments															
Forwards															
Swaps															
Options															
…															
Equity instruments															
Forwards															
Swaps															
Options															
…															
Credit derivatives															
…															
…															
												Total			
Categories of instruments (financial liabilities)															
Interest-rate instruments															
Forwards															
Swaps															
Options															
…															
Currency/gold instruments															
Forwards															
Swaps															
Options															
…															
Equity instruments															
Forwards															
Swaps															
Options															
…															
Credit derivatives															
…															
…															
												Total			

Example I.5. Analysis of financial instruments - Exchange traded derivative instruments held for trading

Derivative instruments held for trading															
Stock exchange	<= 3 months			> 3 months <= 1 year			>1 year <= 5 years			> 5 years			Total		
	Not. v.	Fair v.		Not. v.	Fair v.		Not. v.	Fair v.		Not. v.	Fair v.		Not. v.	Fair v.	
		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year		Aver.	End fin. year
Categories of instruments (financial assets)															
Interest-rate instruments															
Futures															
Swaps															
Options															
…															
Currency/gold instruments															
Futures															
Swaps															
Options															
…															
Equity instruments															
Futures															
Swaps															
Options															
…															
Credit derivatives															
…															
…															
												Total			
Categories of instruments (financial liabilities)															
Interest-rate instruments															
Futures															
Swaps															
Options															
…															
Currency/gold instruments															
Futures															
Swaps															
Options															
…															
Equity instruments															
Futures															
Swaps															
Options															
…															
Credit derivatives															
…															
…															
												Total			

Example II: Information on credit risks - OTC derivative instruments

Credit risk for OTC derivative instruments			(use of the market risk method)			
	Notional amounts* (1)	Current replacement costs* (2)	Potential future replacement costs* (3)	Overall replacement costs* (4) = (2) + (3) - Provisions	Collateral/Guarantees (5)	Net risk exposure (6) = (4) - (5)
Degree of credit worthiness of counterparties (based on external or internal ratings)						
…						
…						
…						
…						
…						
					Total	

Credit risk for OTC derivative instruments			(use of the original risk method)	
	Notional amounts* (1)	Risk-equivalent amounts* (2) - Provisions	Collateral/Guarantees (3)	Net risk exposure (4) = (2) – (3)
Degree of credit worthiness of counterparties (based on external or internal ratings)				
…				
…				
…				
…				
			Total	

* net of the effects of all enforceable netting agreements for which the institution is able to request execution