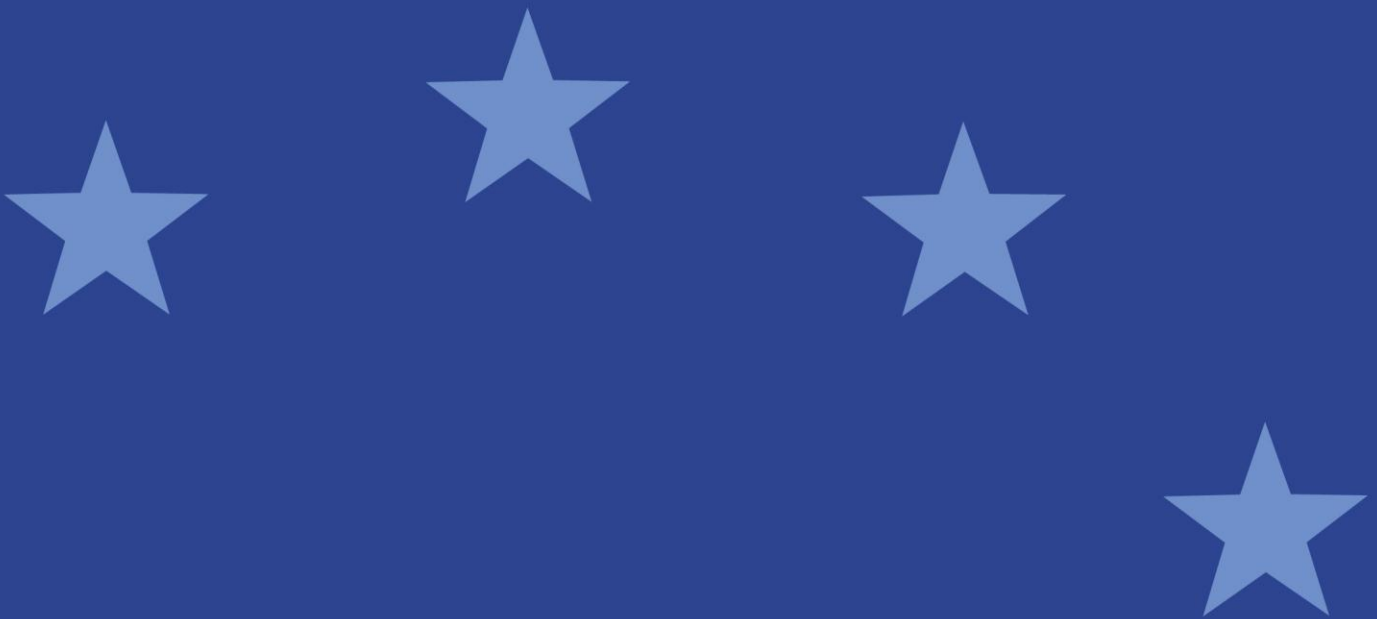




European Securities and  
Markets Authority

## **ESMA Report**

Review of Greek Government Bonds accounting practices in the  
IFRS Financial Statements for the year ended 31 December 2011



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#### Appendix I - Extract from relevant IFRS literature

#### List of abbreviations and acronyms used in this report

CDS	Credit Default Swaps
DCF	Discounted Cash-Flows
EC	European Commission
EU	European Union
GGB	Greek Government Bonds included in PSI
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFRS IC	International Financial Reporting Standards Interpretation Committee
PSI	Private Sector Involvement

## Executive Summary

Throughout 2011 issues relating to the exposure of financial institutions to European sovereign debt, including Greek Government Bonds (GGB), have been under continuous scrutiny by investors. In its Statement issued on 25 November 2011, ESMA emphasised that the measurement and disclosures related to sovereign debt constituted a key issue for the 2011 annual financial statements and called for enhanced transparency. Reference was also made in that statement to specific accounting matters relating to GGB.

In this document, ESMA reports on the findings of a review of the accounting practices and disclosures regarding exposure to GGB in financial statements for the year ended 31 December 2011. The review considered a sample of 42 European financial institutions, each of which had a significant exposure to GGB. Altogether these entities held an estimated (recomputed) gross exposure of around 80 billion Euros.

ESMA found that all issuers in the sample considered that there was evidence of impairment for GGB at the end of 2011. ESMA also observed a good level of consistency as regards the level of impairment losses recognised in the 2011 financial statements. These are areas where consistency of the accounting treatment of GGB has improved compared to the situation observed in the 2011 half year financial statements.

Nevertheless, ESMA considers that issuers fell short of meeting IFRS disclosure requirements and therefore of providing sufficient information to investors in the following key areas:

- All issuers disclosed the amount of their impairment charge in 2011, and all but one disclosed their net exposure to GGB as of 31 December 2011. However, the degree of transparency varied greatly. Only a few issuers disclosed gross exposures, maturities or explanations of yearly variations, which made it difficult for investors to assess the real effect of GGB on the financial performance over the period. ESMA is of the opinion that more detailed information about GGB should have been disclosed, including information on the nature of variations (disposals, recycling of losses, hedging, etc.) in those instruments during the year. Additionally, ESMA observed that not all relevant information on GGB presented in press releases or analyst presentations had always been included in the financial statements, which raises concerns over the quality of the financial statements and the consistency of the communication by issuers of financial matters.
- The valuation methodology used for GGB was disclosed by most issuers, but the quality of disclosures about the levels of the fair value hierarchy varied significantly. In some cases ESMA observed reference being made to level 2 together with an indication that market prices had been used. In the absence of further explanation these two pieces of information seem contradictory. ESMA would have expected issuers to provide explanations about adjustments which had been made to market prices in order to determine the level 2 values, but none were made. Further, ESMA is of the opinion that issuers should disclose the reasons leading to the choice of a fair value level when this choice involves judgement.
- Issuers undertaking an insurance activity used shadow accounting<sup>1</sup> which might result in a reduced impairment loss. Such a practice is industry-specific and may differ from one jurisdiction to the other. ESMA found that impacts of shadow accounting have generally not been disclosed. ESMA believes that not disclosing the effect of the policy surplus reserve on profit or loss for the period impedes comparison with other financial institutions. Further, such a piece of information may be important to assess the performance of the issuer in future periods. Therefore ESMA is of the opinion

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<sup>1</sup> Please refer to section IV.A of the report for additional information on shadow accounting practices

that the effect of the policy surplus reserve should be disclosed in situations where it is significant compared to the issuer's financial performance of the period.

- A number of issuers disclosed that they held CDSs on GGB at the end of 2011, but ESMA identified a lack of transparency in disclosures provided on these instruments and their impact on GGB exposure at year-end. It was sometimes difficult to assess the nature of the CDS exposures and whether issuers were actually buyers or sellers (or both) of these instruments. In some cases, the effect of CDSs was not provided on a country-by-country basis. ESMA is of the opinion that disclosure related to CDSs in the 2011 financial statements did not provide sufficient information to allow users to understand the impact of these holdings on exposures at the reporting date.
- Reclassifications of GGB from one category to another were explicitly mentioned by only a limited number of issuers. While some provided detailed information on reclassified GGB, most issuers only provided aggregated information. ESMA is of the opinion that in some cases disclosures about the reasons for reclassifications should have been more detailed. Disaggregated amounts showing which country's sovereign debt had been reclassified should also have been disclosed in the notes to the financial statements.
- In the weeks that preceded the finalisation of the negotiations with the private sector a debate emerged on whether Greek public sector entities (such as municipalities), other than the Greek government would be included in the PSI. These discussions highlighted the need for transparency on Hellenic Republic guaranteed exposures.
- This report shows that only half of the issuers disclosed information on their Greek non-sovereign exposure, and out of these, only half explicitly disclosed that non-sovereign exposure to Greece had been impaired. In the specific circumstances that prevailed at the end of 2011, ESMA is of the opinion that more detailed information about Greek non-sovereign exposure should have been disclosed in the financial statements.
- The selected issuers almost unanimously assessed that there was no evidence of impairment on exposures to other European sovereign debt at the end of 2011, but only half of the issuers provided explanations to support their judgement. Two exceptions were observed in connection with Portuguese sovereign debt, where small amounts of Portuguese debt were impaired, but no explanations were provided. ESMA is of the opinion that greater emphasis should be put in the financial statements on the reasons why exposures under close scrutiny from the markets are, or are not, impaired.

On the basis of the findings of this review and as a result of market developments, ESMA will focus on:

- The application of IFRS specific and general requirements related to financial instruments and associated risk on the subjects mentioned above;
- Improving transparency of disclosures related to sovereign exposures. ESMA will pay attention to the quality of country-by-country disclosures, and more generally to the granularity of information provided on significant sovereign exposures;
- Improving the disclosures related to non-sovereign exposures by type of exposures (corporate, banks, municipalities, etc.) and to provide qualitative and quantitative information on the credit risk; *and*

- Monitoring further developments related to financial instruments accounting and in particular for sovereign debt in the 2012 IFRS financial statements. This covers, among other things, the accounting treatment of the Greek PSI exchange that occurred in 2012.

ESMA will discuss the detailed outcome of the review with the national competent authorities. ESMA expects these will take or have already taken appropriate enforcement actions in case of infringements and will actively monitor the progress of those actions.

This report focuses on the accounting for and disclosures about GGB, which are currently considered to be subject to increased risk. The principles to which we refer in this report are, however, applicable more generally and should be applied to any material financial instrument exposures that becomes subject to increased risk. ESMA considers that each issuer should assess at every reporting period whether it holds any such instruments and provide disaggregated and expanded disclosures about these instruments to explain the nature and extent of risk. The precise nature of such disclosures will vary in each case. It is expected that issuers will exercise their judgement at each reporting period about which instruments require additional disclosures, and about the nature and extent of these additional disclosures.

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## I. Introduction

1. As a result of the recent sovereign debt crisis and the increased market interest in this area, there has been a lot of attention focused on how this impacted the financial performance of listed financial institutions with exposures to sovereign debt. A particular focus has been on Greece, which suffered significant financial and economic difficulties including issues with its sovereign debt.
2. For these reasons ESMA decided to include this issue in its working priorities for 2012, and to conduct a review of the accounting practices related to Greek government bonds (GGB) by a panel of issuers with significant exposures to such debt at the end of 2011.

### Background

3. European leaders proposed in July 2011 a financial assistance package for Greece in which private bondholders would have been asked to contribute to the relief of Greece's debt burden via a bond exchange (known as the Private Sector Involvement - PSI). That proposal would have resulted in a 21% net present value loss for private bondholders based on an assumed discount rate of 9% and a significant extension in the overall maturity profile of the country's debt.
4. The economic situation in Greece continued to deteriorate and on 26 October 2011 European leaders proposed changes to the PSI plan. Although the detailed features of the plan were not communicated at that moment, generally it was expected that the plan would request private bondholders to accept a 50% reduction in the nominal value of the bonds.
5. The Hellenic Republic announced on 21 February 2012 the key terms of an exchange transaction further to the 26 October 2011 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 GGB to exchange their holdings into new bonds to be issued by the Hellenic Republic.
6. The key terms applicable to each eligible privately held GGB included the following provisions:
  - 53.5% of the principal amount was forgiven,
  - 31.5% of the principal amount was exchanged into 20 new Greek government bonds with maturities of 11 to 30 years, irrespective of their original maturities,
  - the remaining 15% was provided in short-dated securities issued by the European Financial Stability Facility (EFSF).
7. The coupon on the new Greek government bonds was structured so that it was 2% for the three year period from February 2012 to February 2015; then 3% for the following five years (February 2015 to February 2020); and 4.3% for the period from February 2020 to February 2042. Subscribers to the plan also received, for each new bond, a Gross Domestic Product (GDP) linked security of an initial nominal amount of €100. The only amounts payable in respect of these securities are the payments

contingent upon and determined on the basis of the performance of the GDP of the Hellenic Republic.

### **Recent developments**

8. The characteristics of the exchange of debt that took place in March 2012 gave rise to discussions regarding the accounting treatment as of that date. In April 2012, ESMA sent a letter to the IFRS Interpretations Committee asking for clarification on how IAS 39 – *Financial Instruments: Recognition and Measurement* should be applied to the exchange of the GGB. More specifically, the letter asked for clarification on whether the former financial assets should be derecognised upon occurrence of the exchange or should be treated as a modification, on how the GDP-linked securities received in the exchange should be accounted for, and on the initial accounting of new assets when market transactions show that investors take into account a significant credit risk in valuing the instrument.

During its May 2012 meeting the IFRS IC tentatively agreed that full derecognition of old GGB shall apply to this exchange transaction. On the issue of accounting for the newly recognised GDP-linked securities, IFRS IC tentatively agreed that unless the GDP-linked securities are classified as at fair value through profit or loss they would be classified as available-for-sale instruments.

## II. Objectives and scope of the report

9. The main objective of this report is to provide an overview of the accounting practices and to evaluate and compare disclosures on GGB in the financial statements prepared in accordance with International Financial Reporting Standards (IFRS) for the year ended 31 December 2011 of the selected European financial institutions with significant exposure to GGB.
10. The issues selected for review were grouped into the following categories:
  - i. Disclosures related to exposure to GGB, including gross and net exposures, amount of impairment loss, impairment to gross value ratio, and other disclosures providing clarification on the effects on the financial position at year-end;
  - ii. Valuation methods and disclosures about the specific inputs used in the valuation models for various categories of financial assets;
  - iii. Disclosures related to GGB reclassified from one category to another;
  - iv. Disclosures on credit default swaps (CDS) related to GGB, and
  - v. Recognition of impairment losses and disclosures related to exposures to other Greek institutions and exposures to other sovereign bonds.
11. This report has been prepared on the basis of a review of financial information published by 42 European financial institutions that prepare consolidated financial statements under IFRS. The analysis was performed solely on the basis of public information included in the IFRS financial statements as of 31 December 2011 and other publicly available sources (such as press releases and analysts presentations).
12. The initial sample of financial institutions was based on a list of 61 European major listed issuers that stated their intention to participate in the PSI and/or that were included in the stress test performed by the European Banking Authority in 2011. In order to improve the comparability of the final sample, 17 issuers were excluded because their exposure to GGB was not considered to be material for the purpose of this review and two Greek financial institutions were excluded because their financial statements were still not available by 31 May 2012. As a consequence, the final sample (the “sample”) is made of 42 financial institutions with material exposure to GGB, of which 12 belong to the FTSE Eurotop 100 Index.
13. In this sample, seven issuers have audit reports (all related to non FTSE Eurotop 100 issuers) including an emphasis of matter paragraph, in five cases it relates to the GGB exposure while in two cases this refers to going concern assumptions.
14. In the final sample, 21 issuers had only banking activities, five had only insurance activities, and 16 had both of them. The net exposure to GGB as of 31 December 2011 of all financial institutions in the sample amounted to 22.3 billion euro, aggregated by the country of registration for listing purposes of the issuers as follows:



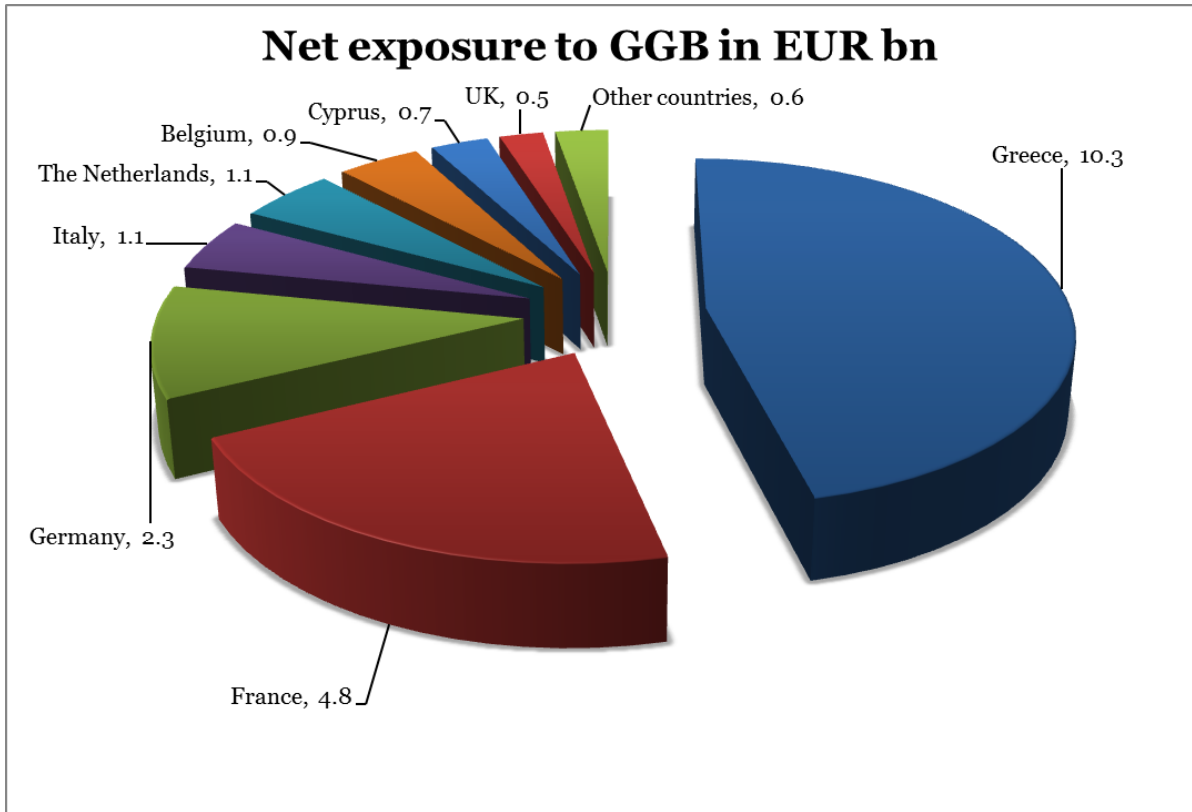


Figure 1: Net exposure to Greek government bonds per EU Member State

### III. Overview of IFRS requirements and ESMA statements

15. When reviewing the IFRS financial statements of the issuers, we analysed the application of the IFRS requirements and of the elements referred to in the statements issued by ESMA in 2011.
16. In 2011 ESMA issued two statements with the aim of improving transparency and consistency of IFRS disclosures related to these matters. On 28 July 2011, ESMA issued a Statement stressing the need for enhanced transparency and the importance of applying the relevant IFRSs and encouraged issuers to provide information on their exposures to sovereign debt on a country-by-country basis.
17. On 25 November 2011, ESMA issued a Statement highlighting elements that had to be considered by issuers and their auditors in relation to exposure to sovereign debt when preparing their financial statements for the 2011 year-end. The Statement stressed the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided for in IFRS. In addition, ESMA reiterated the need for supplementary disclosures explaining the underlying rationale, assumptions and the sources used as inputs to the valuation in the case where a market is not active for a specific instrument.
18. IFRS 7 – *Financial instruments: Disclosures* contains requirements related to disclosures to be provided in the financial statements in order to enable users to evaluate the significance of financial instruments for the entity’s financial position and performance and the nature and extent of risks to which an entity is exposed. IFRS 7 does not contain specific requirements related to disclosure of some of the issues included as subject to our review but the general IFRS principles require disclosure of all relevant information for the users of financial statements.
19. Specifically, IFRS 7 requires qualitative and quantitative disclosures in relation to financial risks and exposures as well as particular information about material risk to which an entity is exposed. Such disclosures would require also maximum exposure to credit risk to which the entity is exposed. Relevant information in respect of exposures to sovereign debt held by entities might be: the level of instruments held by accounting category, the key terms of those instruments including maturity dates, the carrying amounts and fair values of those instruments.
20. As indicated in the ESMA statement from 25 November 2011 “*in order to achieve a fair presentation, as stated under IAS 1 – Presentation of Financial Statements, issuers are required to provide any additional disclosures when compliance with IFRS 7 does not suffice to enable users to understand the impact of sovereign debt to the financial position and performance of the issuer. This is particularly important for areas in which management judgement is applied, as allowed by IFRSs*”. Consequently, a high degree of transparency in disclosures related to the sovereign debt exposures was expected in the IFRS financial statements for the year ended 31 December 2011.
21. IAS 1 paragraph 122 states that an entity shall disclose the judgements that management has made in the process of applying the entity’s accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Additionally, IFRS 7 paragraph 7 provides that an entity shall disclose sufficient information to enable users of its financial statements to evaluate the significance of financial instruments for its financial position and performance (which might include e.g. impairment rate, gross exposure).

22. The IFRS requirements regarding the reclassification of financial assets are laid down in IAS 39. The specific disclosure requirements are included in IFRS 7 which permits a presentation of the relevant information on an overall basis for all financial assets reclassified but does not explicitly require to provide disaggregated information (e.g. for GGB exposure or even more detailed on a country-by-country-basis for all reclassified financial assets). However, taking into account the requirements in IAS 1 paragraph 112(c) and the overall objective of IFRS 7, issuers are expected to provide more detailed information, if the exposure to a particular type of financial asset (for instance GGB) is material.
23. Apart from general principles IFRS 7 does not give specific guidance on disclosures related to CDS. In its November public statement on Sovereign debt, ESMA encouraged providing quantitative and qualitative information on sovereign debt related instruments such as CDS and other instruments, directly referencing to sovereign debt such as financial guarantees, forward contracts, options and other derivatives. ESMA suggested that this disclosure could include the level and the risks to which the issuer is exposed, as well as the estimated level of protection in case a CDS was acquired by an issuer.
24. Whilst GGB is the main subject of this report, general IFRS requirements apply also to disclosure of exposures to other instruments where there may be enhanced risk such as other institutions in Greece as well as to other sovereigns.
25. Abstracts from the relevant IFRS requirements are included in Appendix I.

## **IV. Results of the review**

26. This section highlights the detailed findings and conclusions for each of the subjects identified as main themes subject to review.
27. All issuers in the sample considered that objective evidence of impairment existed on the GGB as of 31 December 2011 and recognised an impairment loss. Out of the 42 issuers in the sample 34 published their annual results after the full terms of the PSI were officially announced (on 24 February 2012), but only 19 issuers made a reference to their intention in participating to the PSI. None of the issuers provided details on the accounting treatment for the exchange of debt that occurred in 2012.
28. Additional information on European sovereign debt exposure based on countries or business segments has been provided outside the notes to the IFRS financial statements (in presentations made to analysts or in press releases) by 11 issuers (out of which 5 are FTSE Eurotop 100 issuers). Such information related to decreases in the exposure to sovereign debt and in some cases the information was more detailed in the presentation to analysts or in the press releases than in the financial statements.
29. Considering the relevance of such information to the market, ESMA would have expected that issuers disclose this information in the IFRS financial statements in order to enable users of the financial statements to evaluate the significance of GGB for the financial position and performance of issuers.

### **A. Exposures, impairment and related disclosure**

30. This part of the report highlights findings and conclusions related to disclosures on: gross and net exposures to GGB, level of the impairment losses and other disclosures on the effects on the financial position at year-end.

#### **Findings**

31. The exposures to GGB as of 31 December 2011 in the sample selected grouped by the jurisdiction of the issuer are summarised in the table below (in billion euro). In addition to GGB, the gross exposure of 80 billion euro includes also other Greek government guaranteed exposures eligible to the PSI.

Jurisdiction	Impairment	Net exposure	Estimated gross exposure <sup>2</sup>
Greece	28.8	10.3	39.0
France	8.0	4.8	12.8
Germany	6.7	2.3	9.2
Italy	3.7	1.1	4.8
The Netherlands	3.2	1.1	4.3
Belgium	2.6	0.9	3.5
Cyprus	1.8	0.7	2.5
UK	1.3	0.5	1.8
Portugal	0.9	0.3	1.3
Spain	0.4	0.2	0.6
Austria	0.1	0.0	0.1
Denmark	0.0	0.0	0.1
<b>Total</b>	<b>57.7</b>	<b>22.3</b>	<b>80.0</b>

Table 1: Exposure to Greek government bonds per jurisdiction of financial institutions in the sample

#### Gross and net exposures

32. All issuers in the sample provided their net exposures to GGB, with one issuer providing this information only in the press release but not in the IFRS Financial Statements. However, three issuers did not disclose how the net exposure was disaggregated between categories of financial assets.
33. More than 40% chose not to disclose the gross amount of bonds they had in their portfolios but only disclosed the impairment charge and net exposure to GGB. Three of those issuers provided information on the nominal amount of the bonds held in their portfolio instead of the gross exposure.
34. Amongst the twelve issuers which held GGB in both the amortized cost and available-for-sale categories, only seven specified the gross exposure split between the categories.
35. The net exposures to GGB as at 31 December 2011 can be analysed following the four IAS 39 categories as follows :

In billion euro	Trading	Available for sale (AFS)	Held to Maturity (HTM)	Loans and Receivables (L&R)	Unallocated	Total
Banking	0.9	3.3	3.5	11.1	0.1	18.9
Insurance	0.0	2.8	0.0	0.3	0.2	3.4
<b>Total</b>	<b>0.9</b>	<b>6.1</b>	<b>3.5</b>	<b>11.4</b>	<b>0.4</b>	<b>22.3</b>
Share per category	4%	28%	16%	50%	2%	100%

Table 2: Net exposure to GGB per category of financial asset

36. Net exposures of the banking division are mainly included in the amortized cost categories. Disclosed net exposure of insurance divisions are quite low (16% of total net exposure). It should how-

<sup>2</sup> The figures shown in the above table reflect the data available in the 2011 published financial statements. The impairment and net exposures are those disclosed by the issuers. Some issuers chose to disclose an impairment charge net of the loss which can be allocated to insurance policy holders. When gross exposures were not disclosed, the above figures are calculated by ESMA based on the impairment charge and the net exposure disclosed by the issuer.

ever be taken into account that issuers did not always disclose whether the published numbers are decreased due to the part of the loss which can be allocated to the policy holders in some local jurisdictions. Therefore the remaining exposure of the insurance sector without the part of the loss that can be allocated back to the policy holders is likely to be higher.

37. None of the issuers in the sample provided a reconciliation of the amounts between 31 December 2010 and 31 December 2011. Therefore it was not possible to distinguish between decreases in exposure due to impairment, disposal, or to changes in fair value. Given the significant reduction in net holdings over the year, disclosure of this information is important. This information was a key issue as some issuers sold significant parts of their exposure in 2011. Only one issuer provided such information explaining in a table the changes between 30 June 2011 and 31 December 2011.
38. One third of the sample provided a maturity analysis for the GGB they held in their portfolio, with only one from the top 25% FTSE Eurotop 100 issuers (the 25% with the largest exposure to GGB) and one of the top 25% non-FTSE Eurotop 100 issuers disclosing this information.

### *Impairment*

39. All issuers disclosed the 2011 impairment loss and around half of the issuers explicitly indicated in the financial statements the impairment ratio (ratio of the impairment charge of 2011 compared to the gross book value as of 31 December 2011). Based on the information included in the financial statements we have computed<sup>3</sup> the impairment rate for the other and found an overall impairment rate of 72.5% for the issuers included in the sample.
40. The impairment rate of issuers belonging to the FTSE Eurotop 100 Index is in line with the impairment rate of the other issuers in the sample. The average level of impairment is consistent with the quotation of GGB on the market as at 31 December 2011 which is disclosed by issuers making a reference to market values<sup>4</sup> (see section B of this Chapter on valuation methods).
41. More than two third of the issuers had a computed impairment rate between 70% and 80% and around 25% of the sample (11 issuers) had a computed rate lower than 70%. Impairment rate below average can be explained in five cases by the insurance policy surplus (shadow accounting) and in one case by the short maturity of the portfolio.
42. Impairment losses per category of financial assets and by industry indicate that a large part of the portfolio (63%) was classified in categories of financial assets accounted for at amortised cost (HTM and L&R):

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<sup>3</sup> Taking such a shortcut calculation implies that a number of factors have not been adjusted for, such as: the tax effect, impact of potential shadow accounting, the effect of revaluation of GGB held in trading portfolio, effects of amounts recycled from the other comprehensive income ("OCI") or effects of related derivative instruments that were disclosed together with impairment loss can influence the computation. Furthermore, depending on the fair value of the GGB at acquisition date, the gross book value of the respective GGB could be low in some cases (e.g. if the GGB was acquired at low market values), which would also lead to lower impairment rates compared to the aforementioned average rate of 72.5%.

<sup>4</sup> Such a comparison can only be made for bonds lines purchased upon issuance at par, and not to GGB acquired when the fair value was lower than the nominal value. The same issue arises when GGB purchased upon issuance were subsequently reclassified.

43.

<b>In billion euro</b>	<b>Available for sale (AFS)</b>	<b>Held to Maturity (HTM)</b>	<b>Loans and Receivables (L&amp;R)</b>	<b>Unallocated</b>	<b>Total</b>
Banking	11.8	7.9	27.2	1.1	48.0
Insurance	8.4	0.2	1.1	0.0	9.7
<b>Total</b>	<b>20.2</b>	<b>8.1</b>	<b>28.3</b>	<b>1.1</b>	<b>57.7</b>
Share per category	35%	14%	49%	2%	100%

*Table 3: Impairment loss per category of financial asset*

44. Out of the 21 issuers with insurance activities 13 had significant GGB exposures related to these activities. All these issuers have contractual and statutory profit sharing mechanisms allowing allocation of some of the losses to their insurance portfolio (this mechanism being known as deferred participation based on shadow accounting):
- 10 issuers mentioned the amount of impairment net of policy surplus reserve;
  - For three of them the accounting principles mention that a deferred participation reserve is recorded. However, no information was given on exposure to GGB and it was not specified if the amounts of exposure and impairment were net of policy surplus reserve or not;
  - Five issuers disclosed the gross exposure before policy surplus reserve and only three of them indicated the amount of policy surplus reserve.
45. Knowing the effect of the policy surplus reserve is important as it is the only way to compare insurance companies within Europe, as this mechanism is not allowed in all countries. Not providing clear information on this subject, while allocating some of the insurance loss back to the policy holders resulted in less transparent overall information and in difficulty for users to compare issuers.

## **Conclusions**

46. Although ESMA had underlined the importance of enhanced transparency in relation to sovereign debt exposure, the majority of the issuers in the sample did not provide information in sufficient detail. While all issuers in the sample provided information related to the impairment charge and net exposure on GGB, the degree of transparency varied. Indeed, knowing only the impairment and net exposure is not sufficient for users of the financial statements to compare issuers.
47. Given the significance of the impact on the financial statements and significant reduction of holdings over the year, enhanced disclosures of gross exposure per category of financial assets, explanation of yearly variation of holdings, details of disposals, recycling of losses from other comprehensive income to profit or loss as well as the extent and impact of hedging activities, would have enabled users to understand the impact of GGB impairment on the financial position and performance of issuers.
48. Before the PSI exchange took place, issuers had portfolios with different maturities, and it would have been useful to disclose the maturity of GGB portfolios. It would have enabled users of the financial statements to see the difference between issuers holding portfolios with long maturities and

issuers holding bonds maturing sooner, as the exchange may have a quite different impact in the two cases.

49. For issuers with insurance activities, presenting the exposure net of policy surplus reserve does not allow market participants to fully understand how much issuers are exposed to GGB. It leads investors to think that insurance companies are less exposed to GGB than, for instance, banks, which may not be the case.

## **B. Valuation**

### **Findings**

50. A significant proportion of the issuers disclosed information related to valuation. Almost one fifth of issuers, none of whom belong to FTSE Eurotop 100 index did not disclose any information at all on the valuation method used for the measurement of the GGB.
51. Very few issuers disclosed whether they had performed an overall or a line by line analysis for all GGB they owned in their portfolio, assessing for each type of bonds what was the impairment charge to be booked.
52. The PSI was quoted for valuation purposes by 13 issuers of the sample, almost exclusively by issuers that used cash flows of the new bonds in their valuation model based on a discounted cash-flows (“DCF”) method.

### *Valuation of GGB measured at amortised cost*

53. 24 issuers had significant exposures to GGB classified in amortized cost categories. In calculating the impairment charge the following methods have been applied:
  - a. 14 issuers applied the discounted cash flow method, out of which 5 indicated also fair value in order to show the coherence between the results of both methods.
  - b. 8 issuers used the market values as a practical expedient; half of these issuers also held aside large AFS portfolios and therefore extended the valuation of this category to the amortized cost category for practical purposes; and
  - c. 2 issuers failed to disclose the valuation method used.
54. Out of the issuers which applied the discounted cash flow method, 10 issuers used cash flows deducted from the PSI, 2 issuers used the contractual cash flows of the old bonds weighted by a probability factor reflecting that the bond exchange was likely to occur and the possibility of an uncontrolled default and 2 issuers did not disclose, even not indirectly, which cash flows had been used.
55. Out of the 14 issuers that used a method based on future cash flows, approximately one third had published their financial statements before the publication of the PSI. Half of these issuers used cash flows derived from the preliminary plan proposals from the private sector, the terms of which were made known on 26 October 2011 and which proved to be close to the final PSI terms. One issuer



used a model based on a conservative analysis of the Greek government credit risk and another issuer did not disclose which cash flows were used.

56. Almost half of issuers disclosed the rate used to discount the cash flows, with differences in the parameters used to determine this rate: 2 used the original effective interest rate, two used market rates at the exchange date, one the rate based on a mix of the market rate and of the new fundamentals of the GGB, and another issuer used the rate which enables to reach market value of the bonds with the new cash flows.
57. This means that a majority of issuers chose to make a reference to market prices, either directly (by using the market value) or indirectly (by comparing the result of their internal cash flow based approach to the market value).

#### *Valuation of GGB held as available-for-sale*

58. From the 30 issuers in the sample with GGB exposure classified as available-for-sale as of 31 December 2011, six provided standard information for each financial asset category but did not provide separately information about the valuation method used for GGB. Out of the 24 issuers which indicated the valuation method used, 19 issuers indicated the use of market values and 5 mentioned the use of a mark to model approach.
59. The 19 issuers which indicated the use of market values can be grouped in the following categories based on the fair value level used:
  - a. Level 1 has been used by 3 issuers
  - b. Level 2 was applied by 6 issuers which justified it by a decreased level of market liquidity
  - c. A mix of level 1 and level 2 was mentioned by 3 issuers based on the analysis of various bonds included in their portfolio
  - d. One issuer disclosed a mix of level 2 and 3 even if it made a reference to market values
  - e. For 6 issuers, no detailed information was provided in order to assess the fair value level used.
60. The 5 issuers who used a mark to model approach argued that market prices were not relevant because of the inactivity of the market. Among these issuers:
  - a. 3 issuers used the assumptions of the PSI that was still under negotiation and one of them gave more details on the model used (spread CDS with a maturity of 5 years and probability of default of the PSI).
  - b. 1 issuer used a mix of market price (30%) and model (70%) based on macroeconomic assumptions (debt/GDP target ratio, performance of the privatisation programme, investment by the various creditors of the Greek government).
  - c. 1 issuer did not explain the assumptions used in the model.
61. Regarding determination of the fair value level, some issuers provided a short explanation with the main concurring that: level 1 users stated that market prices were sufficiently reliable, whereas level

2 users put the emphasis on the decreased liquidity of the market, or stated that they could not use market prices as such and therefore had used prices from reliable sources of information such as quotations from independent providers of market data.

62. Very few issuers explained in detail how they had assessed the fair value measurement and we noticed diversity in explanations focusing on various factors such as: the increasingly thin trading volumes in the secondary market, the small level of transactions and the widening in bid/offer spreads.

#### *Valuation of GGB held in both categories*

63. Out of the sample, 12 issuers had a significant exposure to both available-for-sale and amortized cost categories. Six of these issuers used the same method for both categories: half valued the bonds to the market prices and half valued the bonds with a model. On the other hand, four issuers used a specific valuation methodology for each type of financial asset: a model based on discounted cash-flows for the amortised cost category and a market price for available-for-sale. Finally, two issuers did not provide information on the valuation methodology used for one of the categories.

#### **Conclusions**

64. The valuation methodology was disclosed by most issuers. As far as the valuation methodology is concerned, the discounted cash flow method was used by the majority of issuers which held amortized cost exposures, whereas market value was the main valuation methodology for issuers with exposures classified as available-for-sale. Issuers having exposures in both categories mainly used the same methodology for all exposures (either discounted cash-flows or market value).
65. The cash flows used in the DCF models were almost always described. A majority of issuers used cash flows deducted from the PSI. Other assumptions used, such as the discount rate, were rarely detailed.
66. In its November 2011 Statement, ESMA emphasised the need for issuers to perform an analysis on a line by line basis and use of the appropriate valuation method. Also ESMA highlighted that quoted prices (level 1) should be used if the market is active and level 2 measurements should be applied by using models which maximise the use of observable market data.
67. The fair value level was provided in the notes by two thirds of the issuers in the sample, but there was no consensus among these issuers on whether the markets were active or not. There were also a few inconsistencies between the valuation method used and the fair value level which was disclosed. Only very few issuers explained how they had determined the level used. ESMA observed that when reference was made to model valuation, it was often unclear whether level 2 or level 3 had been used. Further, very few issuers explained how they had determined the level used or why they had deemed it appropriate to use a level 3 valuation.
68. Though there was a good level of consistency between issuers on the valuation of the GGB as of 31 December 2011, ESMA noticed diversity in approaches to valuation as reference was made to level 1, level 2 and level 3. As mentioned in ESMA Statement from 25 November 2011, a market can still be active despite the fact that the level of trading is low. Considering the fact that the main terms of the PSI were already known at the reporting date and that market prices already reflected those terms, it could be argued that giving more weight to non-observable data is acceptable.

69. ESMA believes that issuers should have provided detailed explanations about adjustments made to the market prices in order to determine the fair value levels and the reasons leading to the choice of a certain fair value level when this choice involves judgement. ESMA believes that compliance with IFRS requirements in this regard was not satisfactory.

## C. Reclassifications

### Findings

70. Based on public information, only nine issuers appear to have reclassified GGB from one category to another, but there might have been others which had reclassified in prior reporting periods but have not provided disclosures. It could be assumed that at least five issuers which had significant exposures to GGB categorised as loans and receivables as at 31 December 2011, had in fact reclassified GGB in the past but chose not to provide detailed information on earlier reclassification<sup>5</sup>.
71. The impairment charges on GGB for the 9 issuers amounted to a total of more than 30 billion euro, representing around 60% of the total impairment on GGB. This indicates that in fact those institutions with the largest exposures to GGB presented the information on the reclassification of their GGB investments in a (more) detailed way than those institutions with less significant exposures.
72. The following table shows the reclassifications that took place and the corresponding period:

	<b>AFS to L&amp;R</b>	<b>Trading to L&amp;R</b>	<b>Trading to HTM</b>	<b>Trading to AFS</b>	<b>AFS to HTM</b>	<b>HTM to AFS</b>
<b>2011</b>	3				2	1
<b>2010</b>	3	1	1	2		
<b>2008/09</b>	3		1			

Note: some issuers applied reclassification to more than one category of financial instruments.

73. Notably in the financial year 2011 none of the 9 issuers reclassified GGB from the held-for-trading category to the held-to-maturity category or to the available-for-sale category because of identified “rare circumstances” as was the case three times in 2010.
74. 6 issuers reclassified GGB from the available-for-sale to the loans and receivables category or out of the fair value through profit or loss category and therefore the detailed disclosure requirements of IFRS 7 applied. One issuer from the FTSE Eurotop 100 subgroup provided all the relevant information required by IFRS 7 for its GGB portfolio and also provided information on a country-by-country-basis for other reclassified sovereign bonds (namely Portuguese and Irish sovereign securities). The other issuers provided some of the IFRS 7 required disclosures, whereas other disclosure requirements were only presented on an overall, condensed basis for all reclassified financial assets.

<sup>5</sup> Because a categorization of GGB, which are quoted securities, as loans and receivables at initial recognition would normally not be in line with the definition of loans and receivables (IAS 39.9).

75. The 3 issuers which reclassified in 2011 GGB from the available-for-sale category to the loans and receivables category, justified these reclassifications by characteristics of inactive markets for GGB (such as a “lack of liquidity”, a “significant decline in trading volumes” or a “standstill in the primary market” in combination with “increasingly thin trading volumes in the secondary market”). In one case, further reference was made to the “undertaking given by banks at the request of the authorities not to sell their position”.
76. A few of the 9 issuers did not provide all of the required information in IFRS 7 for reclassified financial assets even on an overall basis. In particular, the effective interest rate and the estimated amounts of expected recoverable cash flows were not provided to the users in these cases.

### **Conclusions**

77. Around one fifth of issuers included in the sample provided specific information about the reclassification of GGB. While some provided detailed information on reclassified GGB, most issuers only provided aggregated information. ESMA is of the opinion that in some cases disclosures about the reasons for reclassification should have been more detailed. Disaggregated amounts showing which country’s sovereign debt had been reclassified should also have been disclosed in the notes to the financial statements.
78. Issuers that did disclose disaggregated information about reclassification of GGB are also the issuers with the largest impairment charges on GGB in 2011. ESMA is of the opinion that in some cases disclosures about the reasons for reclassification should have been more detailed.

## **D. Credit Default Swaps**

### ***Findings***

79. The results of the review indicate that only 13 issuers disclosed holdings of CDS in relation to GGB exposures. The level of disclosure was mixed, and in the absence of any clear guidance, there was little consistency between issuers in what they chose to disclose. Some disclosed both nominal and fair values of CDS while others disclosed only the fair values, in some cases the net fair value. Two disclosed exposures to GGB net of CDS but without disclosing the amounts of the CDS. Some made disclosures at the level of their total Greek exposures rather than separately for sovereign debt. Only three specifically stated that CDS were used to hedge GGB.
80. Although some entities disclosed buy and sell positions separately, others provided only the net. It was not always clear whether issuers were buyers or sellers of CDS on Greek debt. There was limited information about the extent to which these instruments were used for hedging purposes.

### ***Conclusions***

81. In the absence of specific IFRS 7 requirements a number of the financial institutions surveyed responded to guidance issued by regulators<sup>6</sup> and interest by investors by providing additional information at year end. There is, however, a lack of consistency in the level and format of the disclosures and a lack of transparency on the overall impact of CDS holdings on exposures to GGB. Where the use of CDS had a material impact on an issuer’s level of exposure, disclosures should have been suf-

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<sup>6</sup> E.g. ESMA, US SEC

ficient to enable a proper understanding. This might include disclosures of exposures before and after CDS hedging, and details of the hedging policy.

82. There has been considerable discussion about what constitutes default, and whether debt restructurings that have resulted in losses for lenders have been voluntary. Given this uncertainty, the disclosure only of exposures net of CDS protection may not provide adequate information, and information about the protection considered to be offered by CDS or the exposure of sellers of these instruments may be useful.

## **E. Exposure to other institutions and other countries**

### ***Findings***

#### *Exposures to other debt included under the PSI*

83. Seven issuers of the sample disclosed exposures to Greek public sector entities that are guaranteed by the Hellenic Republic and were eligible for the PSI. Three of these issuers did not present the guaranteed exposures separately from the GGB exposures, and one only had government guaranteed exposures and GGB.
84. All issuers but one indicated that these guaranteed exposures included in the PSI have been impaired using the same method as for GGB.

#### *Non-sovereign exposures to Greece*

85. Twenty out of the 38 non-Greek issuers in the sample provided information on their non-sovereign exposure to Greece, generally not specifying whether the exposure towards non-sovereign Greek debt was a direct exposure of the group or an exposure due to Greek subsidiaries. Only four issuers explicitly indicated that they were exposed to non-sovereign Greek debt through their Greek subsidiaries.
86. Out of these 20 issuers, 18 had a total gross exposure amounting to 48.3 billion euro, primarily related to corporates (24 billion euro), customer retail banking (19 billion euro) and financial institutions (1.4 billion euro).
87. Two of them did not disclose their gross exposure, but one disclosed amounts of credit risk related to different types of borrowers. Another one indicated that it was no longer exposed to non-sovereign Greek debt, without specifying the reasons.

#### *Other Sovereign Exposures*

88. The results of the review reveal that two issuers (none of them belonging to the FTSE Eurotop 100) impaired Portuguese sovereign bonds as at 31 December 2011.
89. Around half of the issuers in the sample justified their rationale for not impairing their exposures to other sovereign bonds as of 31 December 2011. The justifications provided mainly concerned Italy, Ireland, Portugal and Spain and indicated that fiscal difficulties are considered less acute compared to Greece or that there was no evidence of impairment as of 31 December 2011. One non FTSE Eu-

rotop 100 issuer also referred to the fact that no private sector involvement is planned outside the Hellenic Republic.

## **Conclusions**

90. Information about non-sovereign exposure to Greece is provided by half of the non-Greek issuers. The non-sovereign exposure primarily relates to banks, real estate, corporates, financial institutions, retail and the local public sector. Nine non-Greek issuers out of 20 with non-sovereign Greek exposure have explicitly disclosed that they have impaired non-sovereign exposure to Greece, although the disclosure is rather minimal. In the specific circumstances that prevailed at the end of 2011, ESMA would have expected that non-sovereign exposure to Greece would be separately disclosed in the financial statements and explanation would be provided why such exposures are considered to be impaired.
91. ESMA is of the opinion that greater emphasis should be put in the financial statements on the reasons why exposures under close scrutiny from the markets are, or are not, impaired.

## Appendix I: Extract from relevant IFRS requirements

IAS 1 paragraph 17(c) requires entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

IAS 1 paragraph 112(c) requires entity to provide information in the notes that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

IAS 1 paragraph 122 requires disclosure of the judgements that have the most significant effect on the amounts recognised in the financial statements.

IAS 1 paragraph 125 provides for disclosure of major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets within the next financial year to be disclosed in the notes to the financial statements.

IFRS 7.IN5(b) The IFRS requires disclosure of (...) *“qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management’s objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel. Together, these disclosures provide an overview of the entity’s use of financial instruments and the exposures to risks they create.”*

IFRS 7 paragraph 7 provides that an entity shall disclose sufficient *“information to enable users of its financial statements to evaluate the significance of financial instruments for its financial position and performance”*.

IFRS 7 paragraphs 16 and 20 require specific information to be disclosed when financial assets are impaired depending on the classification of the assets. Relevant disclosures where financial assets are impaired include: explanation regarding the triggering event; amounts recognised as impairment; reconciliation of changes in the allowance account; amounts reclassified from equity to profit or loss for financial assets classified as AFS and amounts of cumulative loss recognised in other comprehensive income for AFS and, if applicable, for financial instruments previously transferred from AFS to loans and receivables.

IFRS 7 paragraph 25 provides for disclosure of the fair value for financial assets as of the end of the reporting period in a way that permits it to be compared with its carrying amount.

IFRS 7 paragraph 27B requires for all fair value measurements recognised in the statement of financial position the level of fair value hierarchy into which the fair value measurement is categorised in its entirety as well as information on the type of valuation method used according to the fair value hierarchy.

IFRS 7 paragraphs 31 to 35 set up qualitative and quantitative disclosure requirements in relation to financial risks and exposures and how they are managed. IFRS 7.34 (c) requires in particular information about material risks to which an entity is exposed.

IFRS 7 paragraphs 36 to 42 quantitative disclosures related to risk resulting from exposure to financial instruments:

- credit quality of the assets and collateral held by the entity;
- maximum exposure to credit risk at the end of the reporting period, without taking account of any collateral held or credit enhancements;
- counter-party risk: where issuers engage with a limited number of counterparties, potential exposure to these counterparties should be disclosed;
- concentration risk: information on the maturity of assets and concentration in sources of funding would allow users to understand which type of assets cause this risk;
- liquidity risk: explanation of the entity's liquidity strategy and the implications of any risks to that strategy.

IFRS 7 paragraph 40 requires entities to provide a sensitivity analysis for each type of market risk to which they are exposed.

IAS 10 requires entities to provide information on events after the reporting period.

IAS 39 paragraph 58 states that an entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired.

According to IAS 39 paragraph 59 a financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss' event) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

IAS 39 paragraph AG 84 allows a creditor, as a practical expedient, to measure impairment of a financial asset measured at amortised cost on the basis of an instrument's fair value using an observable market price.

IFRS 7 paragraph 31 states that an entity "shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period".

The IFRS requirements regarding the reclassification of financial assets are laid down in IAS 39.50-54. These are accompanied by the disclosure requirements of IFRS 7.12, 12A. In October 2008 the IASB decided to amend IAS 39 in order to permit the reclassification of non-derivative financial assets<sup>7</sup> out of the fair value through profit or loss category in particular circumstances (IAS 39.IN8A). The amendment also permitted entities to transfer a financial asset from the available-for-sale category to the loans and receivables category that would have met the definition of loans and receivables<sup>8</sup> and the entity had the intention and ability to hold that financial asset for the foreseeable future (IAS

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<sup>7</sup> Other than those designated at fair value through profit or loss

<sup>8</sup> If the financial asset had not been designated as available-for-sale



39.IN8A). In October 2008 the IASB also decided to require additional disclosures about the situations in which any the aforementioned reclassifications are made, and the effects on the financial statements and amended IFRS 7 respectively.

The following table summarises the reclassification requirements of IAS 39 paragraph 50-54 and illustrates for which type of reclassification the detailed disclosure requirements of IFRS 7 paragraph 12A apply:

From	To				
	Held-for-trading	Designated at fair value	Loans and receivables	Held-to-maturity	Available-for-sale
Held-for-trading		No	<b>Yes (IAS 39.50D)*</b>	<b>Yes (IAS 39.50B)*</b>	<b>Yes (IAS 39.50B)*</b>
Designated at fair value	No		No	No	No
Loans and receivables	No	No		No	No
Held-to-maturity	No	No	No		Yes (IAS 39.51)
Available-for-sale	No	No	<b>Yes (IAS 39.50E)*</b>	Yes	

\* Detailed disclosure requirements of IFRS 7.12A apply