News Bulletin

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The SEC Staff Issues New Guidance on European Debt Exposures

On January 6, 2012, the staff of the U.S. Securities and Exchange Commission's Division of Corporation Finance (the "Staff") issued guidance regarding disclosures about exposure to the debt of sovereign and non-sovereign issuers in Europe. Topic No. 4 of the Staff's new "CF Disclosure Guidance" series addresses specific concerns about the adequacy of public disclosures made principally by financial institutions regarding their European debt exposures, and the potential consequences of such exposures on those issuers.[1] The Staff encourages affected issuers to consider this guidance in preparing their SEC reports, including in the upcoming annual reports for calendar year-end issuers.

Enhanced Disclosure about Direct and Indirect Exposures

The Staff has focused its attention on disclosure about European debt exposure included (or required to be included) in risk factors, management's discussion and analysis of results of operations and financial condition ("MD&A"), qualitative and quantitative disclosure about market risks ("Market Risk Disclosure"), as well as Industry Guide 3 disclosures required of bank holding companies and similar lending and deposit-taking financial institutions ("Guide 3"). The Staff's guidance in Topic No. 4 is directed at both U.S. and non-U.S. financial institutions, and the Staff notes that, to date, disclosures about the nature and extent of direct or indirect exposure to European sovereign debt "have been inconsistent in both substance and presentation." For this reason, the Staff lays out a very specific structure for evaluating what disclosures may be necessary regarding these exposures, based on the Staff's own experience in commenting on those disclosures that it has, to date, found to be lacking.

In providing its guidance, the Staff has not specifically identified the countries in Europe that are of principal concern, noting that the specific countries may change over time. However, the Staff does indicate that issuers should focus on those countries experiencing "significant economic, fiscal and/or political strains such that the likelihood of default would be higher than would be anticipated when such factors do not exist." The Staff encourages issuers to identify the basis for determining which countries are included in the disclosure.

In recent comments issued by the Staff in its review of periodic reports filed in 2011, enhanced disclosure was requested, separately by country, as to:

- Gross sovereign, financial institutions, and non-financial corporations' exposure;
- Quantified disclosure explaining how gross exposures are hedged; and

[1] CF Disclosure Guidance Topic No. 4, *European Sovereign Debt Exposure*, is provided on the SEC's website at: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic4.htm.

- A discussion of the circumstances under which losses may not be covered by purchased credit protection.

In addition to providing the disclosure separately by country as indicated above, the Staff has requested that issuers segregate between sovereign debt and non-sovereign debt exposures, and by financial statement category, in order to arrive at the gross funded exposure. In addition, the Staff has asked that issuers consider separately providing disclosure of gross unfunded commitments made. Further, the Staff suggests that information regarding hedges be provided in order to present an amount of net funded exposure. As discussed below, the Staff has provided a wide-ranging outline for assessing what qualitative and quantitative disclosures may be necessary regarding direct or indirect exposures to the European debt crisis.

Applicability of Existing Disclosure Requirements

The Staff believes that the disclosures outlined in Topic No. 4 are called for under existing, principles-based disclosure requirements. In this regard, the Staff notes the following applicable disclosure requirements and how they should be interpreted when evaluating what disclosure is necessary regarding European debt exposures:

- *MD&A* — Issuers must identify known trends or known demands, commitments, events or uncertainties that will result, or that are reasonably likely to result, in a material increase or decrease in liquidity; and issuers must also discuss any known trends or uncertainties that have had, or that the issuer reasonably expects may have, a material favorable or unfavorable impact on income.
- *Guide 3* — Item III.C.3 of Guide 3 calls for issuers to identify cross-border outstandings to borrowers in each foreign country where the exposures exceed one percent of total assets, as well as disclosure where "current conditions in a foreign country give rise to liquidity problems which are expected to have a material impact on the timely repayment of principal or interest on the country's private or public sector debt," including tabular disclosure of changes in outstandings, and in some situations tabular disclosure of restructured outstandings.
- *Risk Factors and Market Risk Disclosure* — Issuers must provide disclosure of material risks, including in risk factors disclosure and in specific Market Risk Disclosures, and the Staff indicates that such disclosures should not be generic "boilerplate" and should rather be tailored to the issuer's specific facts and circumstances.

The Staff's Disclosure Checklist

In Topic No. 4, the Staff provides a highly detailed outline for preparing the types of disclosure called for by the guidance. This outline provides considerations to be used when determining, in light of an issuer's specific facts, what disclosure should be provided in a manner that is consistent with the guidance. The outline is as follows:

I. Gross Funded Exposure

  a. Countries

    i. The basis for the countries selected for disclosure.

    ii. The basis for determining the domicile of the exposure.

  b. Type of Counterparty

    i. Separate categories of exposure to sovereign and non-sovereign counterparties.

1. Sovereign exposures consist of financial instruments entered into with sovereign and local governments.

2. Non-sovereign exposures comprise exposure to corporations and financial institutions. To the extent material, separate disclosure may be required between financial and non-financial institutions.

c. Categories of Financial Instruments

i. Categories to be considered for disclosure include loans and leases, held-to-maturity securities, available-for-sale securities, trading securities, derivatives, and other financial exposures to arrive at gross funded exposure.

1. For loans and leases, the gross amount prior to the deduction of the impairment provision and the net amount after the impairment provision.

2. For held-to-maturity securities, the amortized cost basis and the fair value.

3. For available-for-sale securities, the fair value, and if material, the amortized cost basis.

4. For trading securities, the fair value.

5. For derivative assets, the fair value, except that amount could be offset by the amount of cash collateral applied if separate footnote disclosure quantifying the amount of the offset is provided.

6. For credit default contracts sold, the fair value and the notional value of protection sold, along with a description of the events that would trigger payout under the contracts.

7. For other financial exposures, to the extent carried at fair value, the fair value. To the extent carried at amortized cost, the gross amount prior to the deduction of impairment and the net amount after impairment.

II. Unfunded Exposure

a. The amount of unfunded commitments by type of counterparty and by country.

b. The key terms and any potential limitations of the counterparty being able to draw down on the facilities.

III. Total Gross Exposure (Funded and Unfunded)

a. The effect of gross funded exposure and total unfunded exposure should be subtotaled to arrive at total gross exposure as of the balance sheet date, separated between type of counterparty and by country.

b. Appropriate footnote disclosure may be provided highlighting additional key details, such as maturity information for the exposures.

IV. Effects of Credit Default Protection to Arrive at Net Exposures.

a. The effects of credit default protection purchased separately by counterparty or country.

b. The fair value and notional value of the purchased credit protection.

c. The nature of payout or trigger events under the purchased credit protection contracts.

d. The types of counterparties that the credit protection was purchased from and an indication of the counterparty's credit quality.

e. Whether credit protection purchased has a shorter maturity date than the bonds or other exposure against which the protection was purchased. If the credit protection has a shorter maturity date, clarifying disclosure should be provided about this fact, as well as the risks presented by the mismatch of the maturity.

V. Other Risk Management Disclosures

a. How management is monitoring and/or mitigating exposures to selected countries, including any stress testing that is being performed.

b. How management is monitoring and/or mitigating the effects of indirect exposure in the analysis of risk. Disclosure should explain how the issuer identifies their indirect exposures, provide examples of the identified exposures, along with the level of the indirect exposures.

c. Current developments (rating downgrades, financial relief plans for impacted countries, widening credit spreads, etc.) of the identified countries, how those developments, or changes to them, could impact the issuer's financial condition, results of operations, liquidity or capital resources.

VI. Post-Reporting Date Events

a. Significant developments since the reporting date and the effects of those events on the reported amounts.

Impact of the Guidance

As noted in the "Supplementary Information" section of Topic No. 4, the statements in the CF Disclosure Guidance represent views of the Staff, and do not constitute a new rule, regulation or statement of the Commission. Nonetheless, financial institutions preparing disclosure for their SEC reports should carefully consider the disclosure that should be provided in response to the Staff's expectations, as the Staff's outline included in Topic No. 4 will likely serve as a roadmap for the types of comments that the Staff will issue when reviewing the annual reports of any issuers with European credit exposure in 2012. While the Staff has not sought to provide a "one-size-fits-all" approach for these disclosures, Topic No. 4 does seek to provide key principles that need to be considered when evaluating and describing European debt exposures in upcoming SEC reports.

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