Actual Reasons behind the Implementation of Risk Disclosure Guidelines by SECarisingfrom the Euro Debt Crisis and Risk Phenomenon: Conceptual Reviews

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Abstract

A review and discussion of the media report (internet website news) regarding the euro debt crisis is presented in this study. The review points out the essential reactions by the European Union in addressing the enormous risks that they are facing. The study will briefly discuss the published guidelines by SEC and their observation about the disclosure levels of financial and non- financial institutions based on the direct and indirect exposures to the debt occurring in a few European Union countries.

Keywords: European Debt Crisis, Risk Disclosure Guideline by SEC

1. Introduction

Europe's problems in settling its debts in the recent decade are a phenomenon known as the European debt crisis. Portugal, Greece, Spain Ireland, and Italy are five countries in the region that have not been able to make payments that were agree upon to bondholders at various degrees. These five countries are found to be in a critical situation of being default in payment, however, the consequences of has the possibility to reach far beyond the European borders and to affect the whole world. In October 2011, the head of the Bank of England described it as, "the most serious financial crisis at least since the 1930s, if not ever,"

This crisis is now one of the most critical and essential problem that is being faced by the global economy besides being the most difficult to comprehend. The SEC utilized this problem occurring in the EU to implement a guideline for risk disclosure. The following study discusses the conceptual review and offers some causes behind theEuro debt crisis. Subsequently, a brief explanation of the SEC guidelines that uses experimental proof to improve the risk disclosure levels in annual reports will be presented.

2. European Union

The European Union or EU for short is a combination of 27 countries unified into a community of politics and economy in the European region.

It seems like a convenient integration when viewed on the surface but the EU has a history that is rich and unique in its organization. These factors help the successful implementation and its ability to achieve the objectives set out for the 21st Century(Bibow, 2012).

2.1 History

After World War II in late 1940s, the precursor to the European Union began as an effort to unify the European countries and stop the wars occurring among the countries in Europe. In 1949, these countries were officially united under the Council of Europe. This cooperation was further expanded with the establishment of the European Coal and Steel Community in 1950. There were six countries that took part in this treaty namely the Netherlands, Luxembourg, Italy, Germany, France, and Belgium. These countries are known as the founding members of the EU.

In the 1950s during the Cold War, the unrests and divisions between the Western and Eastern Europeans nations called for unification among the European countries. TheTreaty of Rome was established in March 25, 1957 for this purpose which created the European Economic Community that allowed businesses, people and products to smoothly flow with Europe. Many other countries in the regions have joined the EU community in the past decades.

The Single European Act was established in 1987 to further unite the European region with the objective of setting a single market for trading purposes. In 1989 with the demolition of the Berlin Wall, Eastern and Western Europe was further united.

2.2The Present-Day EU

In the 1990s, the single market concept facilitated smooth flowing of trade across borders, encouraged community based discussion on environmental and security issues and smoother travelling across various countries in the EU region.

Although there were prior treaties before the 1990s among the countries in Europe, this period has been recognized as the starting point of the present EU formation which came about after the Treaty of Maastricht that was signed by the participating countries in February 7, 1992 and was fully implemented on November 1, 1993.

The Treaty of Maastricht presented five objectives that were developed to unite the EU in several different methods and not just economically. The objectives are listed below:

1) To establish the unification of economy and finance
2) To reinforce the democratic government of participating countries
3) To intensify the security policy for participating countries
4) To develop the efficiency of the countries
5) To improve social dimension of the community

In view of reaching these objectives, the Treaty of Maastricht has implemented several policies that deal with matters that include education, youth and industry. Furthermore, the treaty also introduced a single currency for EU, namely euro, to execute the implementation of fiscal unity in 1999. By 2008, there were a total of 27 member countries in the EU region.

The Treaty of Lisbon was signed in December 2007, by the member countries with the intention of creating a more efficient and democratic EU by including sustainable development, national security, and climate change.

2.3 Jointhe EU by Countries

There are a number of conditions that must be met if a country was to join the EU as a member. Firstly, the condition is linked to the political dimension. The member countries in the EU must oblige by the democratic system that ensures human rights, democracy, rule of law and protecting minorities' rights. Further to the political dimension, the economic dimension is also equally important; the country's economy must be established enough to compete in the EU market place.

Lastly, the interested country must willingly adhere to the EU's objectivesin terms of economy, politics and finance matters. They must be willing to participate in the judicial and administrative structures of the EU region. Once the potential country is found to have met these requirements, it is screened and approved by the Council of the European Union and a draft of the country's Treaty of Accession is given to the European Commission and European Parliament for ratification and approval. When this process is successful, then the country is considered a member state of the EU.

2.4 Functions of EU

It is a challenging task to govern the EU as there are many different countries in it. However, the structure is always changing to transform into the most effective system possible for current times. At present, the "institutional triangle" that consists of the European Commission that upholds Europe's main interests, the European Parliament consisting of the people, and the Council consisting of national governments, work to create the laws and treaties.

The official name of the council is the Council of the European Union and is responsible for the main decision making. The council has a President and the position is rotated among the member states every six months. Furthermore, the legislative power and important decisions are conducted with a majority vote, a unanimous vote, or a qualified majority by the representatives of the member states.

The European Parliament consists of the representatives from the EU and takes part in the legislative process of EU. Therepresentativesare elected every five years.The European Commission oversees the EU and theirrepresentative that are chosen by the Council for a period of five years; each member state has one Commissioner. The primary role of the Commission is main job is to support the EU's common interests.Besides the three main divisions, the EU consists ofcommittees, banks, and courts thatare responsible for matter pertaining to the successful management of the EU.

2.5The EU's Mission

From the time that it was founded in 1949, through the establishment of the Council of Europe, the EU's mission has been to have sustained prosperity, communication freedom, smooth travel and trade among the citizens. The EU sustains its mission by engaging in several treaties that enables it to function with cooperation from the member countries and its special structure of government

3. The Beginning of the Euro Zone Crisis

Ever since the financial crisis of 2008-2009 in the US, global economy has hit a slow growth. The crisis has exposed the unattainable fiscal policies of European countries and other countries around the world.

Greece which had overspent for many years and did not conduct any fiscal reforms has been one of the first countries to suffer in this crisis due to poor growth. Given the poor growth, the tax revenues have also lowered making the high budgets deficits not reachable(Bibow, 2012; De Santis, 2012).

In 2009, the new Prime Minister then, George Papandreou, had to make announcement regarding the country's deficit which the previous government had failed to declare. Greece's debt was in fact larger than the country's whole economy and the issue could not be hidden any longer. Higher yields were demanded by the investors of Greece's bonds which further increased the cost of the country debt. Greece had to be bailed out by the EU and the European Central Bank (ECB). The bond yields were driven up by the market in other countries in the EU that were also indebted where investors anticipated the same problem to occur(Lane, 2012).

4. *Why do Bonds Yields Increase in Response to this Type of Crisis, and what are the Consequences?*

The cause of the increase in bond yield is that when investors view a higher risk linked to the investment in a country's bond, they would want more returns as compensation for the risk taken. This in turn creates a nasty cycle that cause more fiscal strain making the investors to ask for even increased yields. The loss in investor confidence has an effect on the selling in not only the country involved but also in other countries with fragile finances; this phenomenon is known as the 'contagion'(Hui & Chung, 2011).

5. *Reaction of the governments in Europeabout the crisis*

The EU has been forced to remedy the situation; however, the process has taken a long time as all the 17 countries need to agree to suggestions offered. The main strategy at present has included a series of bailouts for the countries that are suffering economically. Greece was bailed out at the price of 110 billion Euros (the equivalent of $163 billion) in the spring of 2010 by the European Union and International Monetary Fund. In the middle of 2011, another bailout was carried for Greece at the rate of $157 billion. The creditors were offered a debt restructuring plan in March 9, 2012 which involved another round of bailouts. In November 2010, Ireland received a bailout, while Portugal was given a bailout in May 2011. The European Financial Stability Facility (EFSF) was created by the Euro zone member states to offer emergency financial help to countries facingfinancial difficulty(Wood, 1986).

The European Central Bank was also part of the bailout plan.In August 2011, the ECB introduced a strategy to buy the government bonds so that they can maintain the yields from increasing to a level where it would be impossible for countries like Spain and Italy to pay.The ECB offered the availability of credit as much as €489 ($639 billion) in December 2011 to some of the distressed banks in the region at very low rates; in February 2012, another round of the credit facility was offered.

The program was called the Long Term Refinancing Operation (LTRO). Many of the financial institutions had increasing debts towards 2012, which made reduce loans and keep their reserves. The reduction in loans causes slower economic growth and causes the crisis to worsen. In order to boost the financial institutions' balance sheets the ECB attempted to stall this possible problem.

The actions taken by the policy makers in the EU assisted in stabilizing the financial markets for a short term, however, there was a lot of criticism saying that the solutions were short lived and in fact the actions just postponed the actual disaster. While a small country like Greece could be helped with bailouts by the ECB but bigger countries like Italy and Spain may not be saved using the same measures. The key issue was the critical state of the countries' fiscal position and its impact on the markets from 2010 to 2012.

6. Default a Major Issue, Possibility For a Country To Just Ignore Its Debts And Start Afresh

The solution is not so straightforward due to a critical point: The banks in Europe are the major holders of the EU governments' debts even though the position has been decreasing from the second half of 2011 onwards. In general, financial institutions are required to keep a balance between the amount of debt they have and their assets. When a country defaults on their debt payment, the value of the bond drop tremendously. This causes a huge reduction in the total assets of the banks' balance sheets and may lead to insolvency. Given the global connectivity of financial systems, banks do not function in a vacuum. There could a domino effect that may lead to a series of banks facing the same destructive path.

A perfect example of this scenario is the effect of the US financial crisis. A number of continuous collapses by smaller banks finally caused the major chaos in Lehman Brothers resulting in government's bailouts and forced takeovers. In Europe, the governments themselves are struggling to grow their economy and as such, they would have less latitude to assist unlike the scenario in US.

7. The Debt Crisis in Europeaffected the Financial Markets

A potential contagion has caused the debt crisis in Europe to be a major focus of global financial markets from 2010 to 2012. Given the 2008/2209 global crisis still fresh in people memory, investors have reacted quickly to the adverse news in markets in Europe –sell anything that is too risky and only buy governments bonds from countries that are financially sound.

At the pinnacle of the financial crisis, the European markets and bank stocks performed very poorly compared to the other global players. The bond markets in the European countries also had bad yields since the increased yields meant that the prices were dropping. During that period, US Treasury yields also fell to an all-time low as a result of the investors 'fleeing to safety'.

8. The Political Implications

The crisis has brought about enormous political implications. In the countries that have been affected, the severe measures and cost cutting maneuvers to decrease the outlays and revenues, has caused a lot of public outcry and protests in Greece and Spainand the elimination of the ruling parties in Portugal and Italy. Among the stronger fiscal countries, there has been tension as well such Germany which wanted Greece and the other affected nations to conduct a budgetary reform as a precondition to offering bailouts; this has led to further chaos among the EU countries.

After much discussions and confrontations, Greece was forced to agree to cost cutting and raising taxes solutions. A major barrier has been Germany's disagreement on a solution that is regional which would include the issuing of bonds by all the countries in the EU because then Germany would have to own a larger amount of that bill.

This conflict has given rise to the possibility that one or more EU nations may forgo the use of the euro which is the common currency in the EU at present. However, abandoning the euro would mean that the country is on its own and not part of the policy set out by the EU about using the euro. This has a very significant implication on the international financial markets and the global economy. Due to this uncertainty, the euro has been hit harder in comparison to other currencies during the crisis(Lynn, 2010).

9. The Fiscal Austerity the Solution

The austerity measures pushed by Germany include increased taxes and reduced spending. This could pose many challenges to the smaller countries since lower government expenditure will result in a weak growth which in turn will lead to decreased tax revenues and further struggle in paying loans. This scenario would make it very difficult for the highly-debt countries to free themselves from. There have been huge public protests with the proposal of reduced government expenditure which caused the policy makers to be unable to accomplish the necessary steps to solve the crisis. In late 2011, the whole region went in recession mainly due to these solutions and the general loss of confidence among investors and businesses.

However, the wealthier nations in Europe have no choice but force the poorer nations to reduce their spending as the wealthier nations are answerable to their own citizens who are not happy with the bailout to the poorer countries.

In countries such as France and Germany, the taxpayers have not been happy with funding to Greece and other countries in trouble as they see these countries as having overspent their money. These conflicts of opinions and disagreements have made it very complicated to find a solution to the crisis.

10. From a Wider Perspective, this Concern to the United States

The global financial system is fullyan interconnected network which means that a financial which happens in a country like Greece in EU region has the potential to have a global effect. The EU debt crisis has affected the financial markets as well as the budget of the US government. The International Monetary Fund's (IMF) capital is derived from the US as much as 40%; as such when the IMF has to offer bailouts, the US taxpayers will also face the brunt of it. Furthermore, the US debt has also been increasing at a steady pace which means that the crisis in Greece and Europe could be a possible warning signal for policymakers in US especially with the 'fiscal cliff'predicted at the end of this year.

10.1 SEC's Disclosure Guidelinesbased on the European Sovereign Debt Exposures

SEC states that the currentsovereign debt crisis in Europe along with the market fluctuation and uncertainties in the global economy has caused adverse effects on many firms. Given this scenario, it is critical that all SEC registrants who are compiling their annual reports, or are in the process of offering such documents, to reevaluate their risks and financial related to the effects of the current crisis (SEC, 2012).

10.1.1 Financial Institutions

SEC states that the division of Corporation Finance published guidelines on January 6, 2012 to develop the comparability and clarity in a larger scale that would assist the registrants to decide which information should be disclosed in view of the European sovereign debt crisis. These guidelines consist of the opinions of the Division of Corporation Finance and do not introduce any new rules, disclosure or regulations requirements by the SEC. It was reported by the Division that it has offered suggestions based on the reports asking the registrants for disclosure in each country (SEC, 2012)

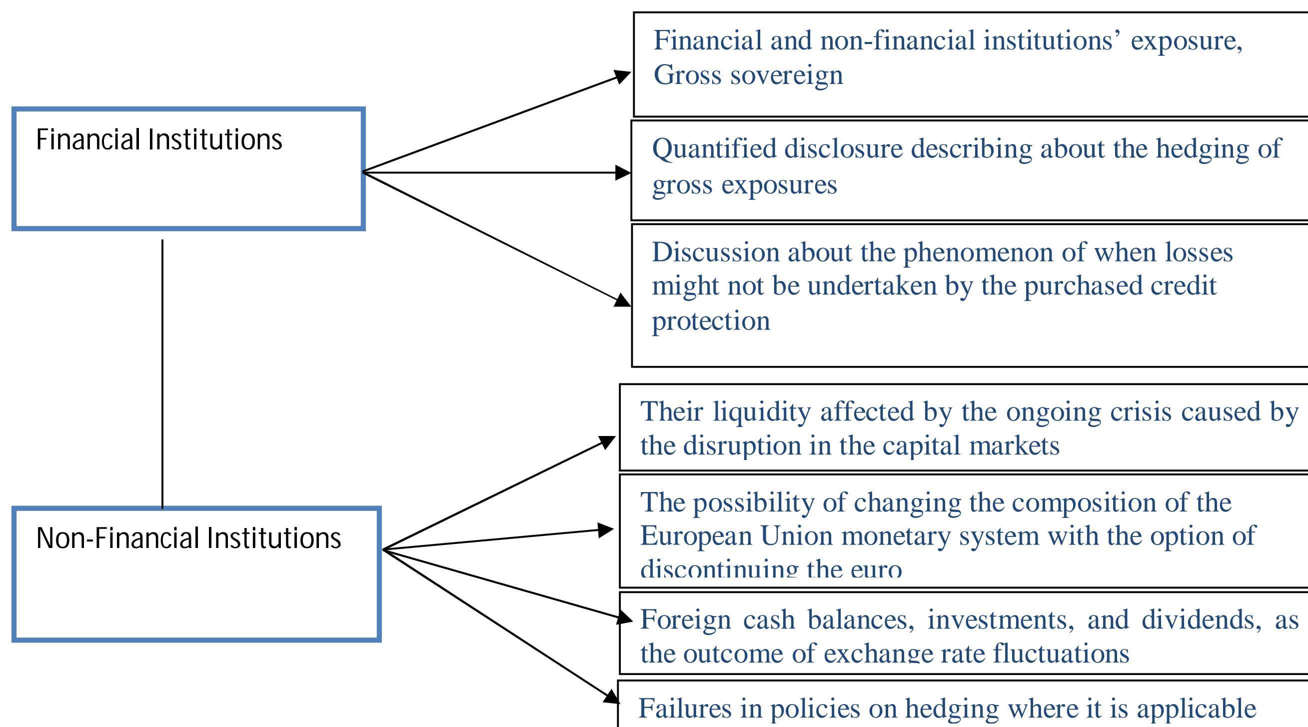

Figure1: SEC risk disclosure guideline

SEC states that the guidelines are concentrated on the requirement for a higher level of disclosure so that the participants are able to adhere to the requirements of the four current principles based on disclosure namely:Identified patterns and risks: Firms are needed to present any pattern, demand, event, or uncertainty, andcommitment, in their Management's Discussion & Analysis (MD&A) disclosure unless the firmsare able to confirm that such a risk will not occur or that the effect of the risk will not affect the firm's operations, capital or liquidity resources; industry Guide 3-Bank Holding Firms: Under the Guide 3 disclosure, registrants must name the country and the aggregated amount of outstanding debt of the country where the outstandings are more than 1% of total assets. In addition, they must also present a detailed discloser which includes changes in outstandings especially when the situation in the foreign country has caused liquidity issues which will have a material effect on repayment of borrowings on a timely basis; risk Factors: Regular reports are needed to be presented of the most important risks to the registrants and the industry that has invested in the firm's securities; market Risk, registrants are needed to present aqualitative and quantitative market risk disclosure reporton their portfolios.

SEC states that in the newly developed guidelines, the Division of Corporation Finance proposes that in offering a higher level of disclosure regarding the registrants' exposure to European debt, these disclosuresmust be based on divided by sovereign and non-sovereign exposures; offered on a country-by-country basis; and divided by financial statement classificationsthat show the gross financial exposure, as deemed suitable. The guidelines also proposed that registrants should take into consideration thedisclosure of gross unfunded commitments; and provide information about hedges that show the quantity of the net funded exposure.

SEC states that firstly, registrants should focus on countries that are going through a prominent fiscal, economic or political crisis that the firm foresees would raise the default possibility. Firms should take into consideration on pointing out the reason for selecting the countries involved.

The publication by SEC consists of a list with details of the requirements that the registrants are asked to consider when preparing the disclosure report in adherence to the guidelines. Secondly, Registrants should take into consideration the risk management strategies' disclosure such as how it is being mitigated or monitored from the exposure to the chosen countries directly and the indirect impacts of these exposures. The disclosure should also include development plans of the chosen countries, which include downgrade of ratings, and financial relief strategies since it will have an impact on the registrants' financial position, outcome of their operation, capital resources and liquidity. In conclusion, the registrants should also take into consideration if any important post-reporting date occurrences require disclosure.

10.1.2 Non-Financial Institutions

SEC states that firstly, the registrants, which were non-financialinstitutions, and were also directly or indirectly exposed to the European sovereign debt caused by the debt crisis, would also have to take into consideration the Division of Corporation Finance's guidelines in examining their disclosures in this area. The registrants also needed to update and includetheir MD&A and risk related information pertaining to risks and uncertainties caused by the present economic and fiscal phenomenon. The risk factors and disclosure carried out during the economic crisis in 2008 and 2009 in periodic reports and providing documentationwas helpful and should be continuedto update with current developments. Specifically, the risk factors should point out the particular aspects linked to the European sovereign debt crisis and the uncertainty resulting from the condition in the EU.

For instance, besides disclosing the risks related to the debt crisis, they could also highlight the risks associated with these allocations ,their liquidity level caused by the problems in the capital markets resulting as a result of the continuous crisis; a possible transformation to the make-up of the European Monetary Union, that included the possibility of abolishing the euro currency; foreign cash balances, investments, and dividends as a result of the variations in exchange rates; andwhere applicable, the failures of the hedging policies. Secondly the registrants would also be required to disclose the known uncertainties and trends as a result of the challenges faced in the economy, and the European sovereign debt crisis, that may have an effect on their capital resources, liquidity, or results of their operations in their MD&A.

11. Future for the Crisis and Conclusion

Europe was very much in trouble as at May 2012. It was noted in Bloomberg,that economists from Citigroup suggested a 75% possibility that Greece could leave the euro following its elections later in the year, considering that the country's latest bailout package would possibly be rejected. Furthermore, more than 50% of the investors who participated in a survey conducted by Bloomberg predicted the exit of an EU member some time in 2012. There is a possibility that this would result in more regional and global economic turmoil which would last for many more years to come. The Institute for New Economic Thinking believes that faith must be restored in the EU with the promise of a better future, stability and greater welfare. In conclusion, after this event, the SEC offers guidance in overcoming this situation by improving the risk disclosure guidelines so as to positively react to further risk scenarios and crises. It can be possible for any domination around the world to aware of facing any financial crisis.

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