



Promoting stability

Insights into new recommendations for banks' risk disclosures

Introduction

The recommendations of the Financial Stability Board's Enhanced Disclosure Taskforce (EDTF) represent a significant development in the way in which banks report risk to their stakeholders.

Problems identified in the EDTF report include:

- persistently high credit spreads;
- the fact that many banks are trading at market values below their book values; and
- the significant liquidity support being provided by the public sector to certain banks.

To help tackle these, the EDTF has developed recommendations to improve the clarity, timeliness and usefulness of information that banks provide to investors. Specifically, it recommends banks reduce opacity in their reporting by better explaining their business model; providing more detailed information on the composition of capital and how risk-weighted assets are calculated; and setting out more explicitly the manner in which market and credit risks affect them.

The intention is that improvements to the quality of banks' risk disclosures will prevent a repeat of the loss of confidence that occurred during the financial crisis because banks' reports did not always provide the information investors sought. Banks will need to consider how they will respond to users' demands for clearer risk information, including assessing whether the governance and controls over the production of such information are fit for purpose.

Established in May 2012 by the Financial Stability Board (FSB) in response to the concerns set out above, the EDTF was tasked with identifying leading risk disclosures and developing recommendations to improve the quality of risk reporting by the worlds' largest and systemically most important banks. Since then, EDTF members have met in London, New York, Singapore and Frankfurt to establish what additional information users most want to see and what barriers to providing the desired disclosure exist.

The EDTF's report '**Enhancing the Risk Disclosures of Banks**' was published in October 2012 and is expected to drive improvements in the quality and comparability of banks' risk disclosure from as early as December 2012 reporting periods. Adoption of the recommendations is voluntary rather than mandatory, but it is possible that regulators might seek to impose new requirements if banks do not work actively to develop their disclosures along the lines proposed by the EDTF.

Taskforce membership

The EDTF was co-chaired by individuals with a broad knowledge of banks' risk reporting: Hugo Bänziger (formerly Deutsche Bank), Russell Picot (HSBC) and Christian Stracke (PIMCO). It included members from the investor and analyst community; major retail and investment banks from the Asia-Pacific region, US and Europe; and audit firm representatives from London, Hong Kong and New York. A distinctive feature of the group was its collaborative approach including users and preparers of financial reports. This has resulted in recommendations for risk information which meet market demands and are practical for banks to deliver.

What is the Financial Stability Board?

The Financial Stability Board (FSB) was established by the G20 in 2009 to coordinate at the international level the work of national financial authorities and international standard-setting bodies and to promote the implementation of effective regulatory, supervisory and other financial sector policies. It is chaired by Mark Carney, Governor of the Bank of Canada. Its members include banks, regulators and standard-setters from across the world. Its secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements.

Structure of the EDTF report

The EDTF's report includes fundamental principles for enhanced disclosure. It identifies seven key areas of risk, each of which had a separate workstream and for which separate disclosure recommendations have been developed. The recommendations capture existing good practices from banks across the world and the report reproduces some of these leading disclosures to illustrate what can be achieved. As well as including current risk disclosures that users rate highly, the report includes proforma tables illustrating some of the EDTF's proposals. Although the report is aimed at the world's largest banks, much of the content will also be relevant to smaller banks and to financial institutions other than banks.

Principles for risk disclosure

The EDTF's seven fundamental principles are that risk disclosures should:

1. be clear, balanced and understandable;
2. be comprehensive and include all of the bank's key risks;
3. present relevant information;
4. reflect how the bank manages its risks;
5. be consistent over time;
6. be comparable among banks; and
7. be provided on a timely basis.

These high-level principles were developed to provide a strong foundation from which to achieve transparent, high-quality risk disclosures that enable users to understand in an integrated manner a bank's business and risks. They provide a basis for disclosure recommendations to be developed in the seven key risk areas identified by the EDTF:

1. risk governance and risk management strategies/ the business model;
2. capital adequacy and risk-weighted assets;
3. liquidity;
4. funding;
5. market risk;
6. credit risk; and
7. other risks (including fraud, technological and operational risks).

The group developed 32 recommendations shown on page 3-4, supported by illustrative tables and explanatory commentary. Together these covered a wide range of aspects of risk disclosure, including content, location and timing.

Starting with governance and risk management, there was a consensus that banks' management generally could provide better explanations of what they saw as the top and emerging risks affecting them, how they thought these might change, and how they planned to manage them. The objectives for managing the individual risk areas ought to align with the overall approach to governance. For large and diverse banks, ensuring risk disclosures for each of the separate risk areas identified tie in consistently with their overall business model and governance will take time.

The EDTF recommends that significant risk information be published together with the annual report; at the moment the release of information can be piecemeal. For example, Basel II Pillar III risk information may only become available months after the annual report, giving users a fragmented picture of a bank's risk management.

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The EDTF's recommendations

General

1. Present all related risk information together in any particular report. Where this is not practicable, provide an index or an aid to navigation to help users locate risk disclosures within the bank's reports.
2. Define the bank's risk terminology and risk measures and present key parameter values used.
3. Describe and discuss top and emerging risks, incorporating relevant information in the bank's external reports on a timely basis. This should include quantitative disclosures, if possible, and a discussion of any changes in those risk exposures during the reporting period.
4. Once the applicable rules are finalised, outline plans to meet each new key regulatory ratio, e.g. the net stable funding ratio, liquidity coverage ratio and leverage ratio and, once the applicable rules are in force, provide such key ratios.

Risk governance and risk management strategies/business model

5. Summarise prominently the bank's risk management organisation, processes and key functions.
6. Provide a description of the bank's risk culture, and how procedures and strategies are applied to support the culture.
7. Describe the key risks that arise from the bank's business models and activities, the bank's risk appetite in the context of its business models and how the bank manages such risks. This is to enable users to understand how business activities are reflected in the bank's risk measures and how those risk measures relate to line items in the balance sheet and income statement.
8. Describe the use of stress testing within the bank's risk governance and capital frameworks. Stress testing disclosures should provide a narrative overview of the bank's internal stress testing process and governance.

Capital adequacy and risk-weighted assets

9. Provide minimum Pillar 1 capital requirements, including capital surcharges for G-SIBs and the application of counter-cyclical and capital conservation buffers or the minimum internal ratio established by management.
10. Summarise information contained in the composition of capital templates adopted by the Basel Committee to provide an overview of the main components of capital, including capital instruments and regulatory adjustments. A reconciliation of the accounting balance sheet to the regulatory balance sheet should be disclosed.

11. Present a flow statement of movements since the prior reporting date in regulatory capital, including changes in common equity tier 1, tier 1 and tier 2 capital.
12. Qualitatively and quantitatively discuss capital planning within a more general discussion of management's strategic planning, including a description of management's view of the required or targeted level of capital and how this will be established.
13. Provide granular information to explain how risk-weighted assets (RWAs) relate to business activities and related risks.
14. Present a table showing the capital requirements for each method used for calculating RWAs for credit risk, including counterparty credit risk, for each Basel asset class as well as for major portfolios within those classes. For market risk and operational risk, present a table showing the capital requirements for each method used for calculating them. Disclosures should be accompanied by additional information about significant models used, e.g. data periods, downturn parameter thresholds and methodology for calculating loss given default (LGD).
15. Tabulate credit risk in the banking book showing average probability of default (PD) and LGD as well as exposure at default (EAD), total RWAs and RWA density for Basel asset classes and major portfolios within the Basel asset classes at a suitable level of granularity based on internal ratings grades. For non-retail banking book credit portfolios, internal ratings grades and PD bands should be mapped against external credit ratings and the number of PD bands presented should match the number of notch-specific ratings used by credit rating agencies.
16. Present a flow statement that reconciles movements in RWAs for the period for each RWA risk type.
17. Provide a narrative putting Basel Pillar 3 back-testing requirements into context, including how the bank has assessed model performance and validated its models against default and loss.

Liquidity

18. Describe how the bank manages its potential liquidity needs and provide a quantitative analysis of the components of the liquidity reserve held to meet these needs, ideally by providing averages as well as period-end balances. The description should be complemented by an explanation of possible limitations on the use of the liquidity reserve maintained in any material subsidiary or currency.

Funding

19. Summarise encumbered and unencumbered assets in a tabular format by balance sheet categories, including collateral received that can be rehypothecated or otherwise redeployed. This is to facilitate an understanding of available and unrestricted assets to support potential funding and collateral needs.
20. Tabulate consolidated total assets, liabilities and off-balance sheet commitments by remaining contractual maturity at the balance sheet date. Present separately (i) senior unsecured borrowing (ii) senior secured borrowing (separately for covered bonds and repos) and (iii) subordinated borrowing. Banks should provide a narrative discussion of management's approach to determining the behavioural characteristics of financial assets and liabilities.
21. Discuss the bank's funding strategy, including key sources and any funding concentrations, to enable effective insight into available funding sources, reliance on wholesale funding, any geographical or currency risks and changes in those sources over time.

Market risk

22. Provide information that facilitates users' understanding of the linkages between line items in the balance sheet and the income statement with positions included in the traded market risk disclosures (using the bank's primary risk management measures such as Value at Risk (VaR)) and non-traded market risk disclosures such as risk factor sensitivities, economic value and earnings scenarios and/or sensitivities.
23. Provide further qualitative and quantitative breakdowns of significant trading and non-trading market risk factors that may be relevant to the bank's portfolios beyond interest rates, foreign exchange, commodity and equity measures.
24. Provide qualitative and quantitative disclosures that describe significant market risk measurement model limitations, assumptions, validation procedures, use of proxies, changes in risk measures and models through time and descriptions of the reasons for back-testing exceptions, and how these results are used to enhance the parameters of the model.
25. Provide a description of the primary risk management techniques employed by the bank to measure and assess the risk of loss beyond reported risk measures and parameters, such as VaR, earnings or economic value scenario results, through methods such as stress tests, expected shortfall, economic capital, scenario analysis, stressed VaR or other alternative approaches. The disclosure should discuss how market liquidity horizons are considered and applied within such measures.

Credit risk

26. Provide information that facilitates users' understanding of the bank's credit risk profile, including any significant credit risk concentrations. This should include a quantitative summary of aggregate credit risk exposures that reconciles to the balance sheet, including detailed tables for both retail and corporate portfolios that segments them by relevant factors. The disclosure should also incorporate credit risk likely to arise from off-balance sheet commitments by type.
27. Describe the policies for identifying impaired or non-performing loans, including how the bank defines impaired or non-performing, restructured and returned-to-performing (cured) loans as well as explanations of loan forbearance policies.
28. Provide a reconciliation of the opening and closing balances of non-performing or impaired loans in the period and the allowance for loan losses. Disclosures should include an explanation of the effects of loan acquisitions on ratio trends, and qualitative and quantitative information about restructured loans.
29. Provide a quantitative and qualitative analysis of the bank's counterparty credit risk that arises from its derivatives transactions. This should quantify notional derivatives exposure, including whether derivatives are over-the-counter (OTC) or traded on recognised exchanges. Where the derivatives are OTC, the disclosure should quantify how much is settled by central counterparties and how much is not, as well as provide a description of collateral agreements.
30. Provide qualitative information on credit risk mitigation, including collateral held for all sources of credit risk and quantitative information where meaningful. Collateral disclosures should be sufficiently detailed to allow an assessment of the quality of collateral. Disclosures should also discuss the use of mitigants to manage credit risk arising from market risk exposures (i.e. the management of the impact of market risk on derivatives counterparty risk) and single name concentrations.

Other risks

31. Describe 'other risk' types based on management's classifications and discuss how each one is identified, governed, measured and managed. In addition to risks such as operational risk, reputational risk, fraud risk and legal risk, it may be relevant to include topical risks such as business continuity, regulation compliance, technology, and outsourcing.
32. Discuss publicly known risk events related to other risks, including operational, regulation compliance, and legal risks, where material or potentially material loss events have occurred. Such disclosures should concentrate on the effect on the business, the lessons learned and the resulting changes to risk processes already implemented or in progress.

Improvements to disclosures of capital adequacy and risk-weighted assets were identified by the EDTF. These included more detailed analysis of the sources of regulatory capital requirements and flow information showing how capital and risk-weighted assets change from one reporting period to another. Indeed, the provision of better 'flow' information setting out change from one period to the next is a recurring theme in the EDTF's work; for example, more information on how impaired and non-performing loans develop from period to period is also sought. To improve disclosure about finding, the EDTF recommends that banks provide analyses of encumbered assets and assets that constitute the liquidity buffer, along with residual contractual maturity analysis of assets and liabilities.

The Taskforce found there is significant scope for market and credit risk disclosures to improve. In particular the volatility associated with the trading book could be the subject of more detailed disclosure. For traded market risk, for example, banks should provide more detailed analysis of risk factors, including credit and debit valuation adjustments. Banks should also provide quantitative and qualitative disclosures that describe the methods for measuring tail risk. These would explain potential losses beyond reported confidence levels that are measured through expected shortfall, stress tests, scenario analysis, Basel 2.5 stressed Value at Risk (VaR) or alternative methods.

Granting credit is what banks do: credit risk is accordingly a significant component of their overall risk profile. Deloitte UK partner Mark Rhys chaired the workstream focussed on credit risk, which found that 'traditional' sources of credit risk, such as residential mortgages were generally disclosed more clearly than newer sources of credit risk, such as those arising from trading activities. Identifying concentration risk in relation to different counterparties, establishing the quality of collateral mitigating credit risk and understanding what drives change in credit risk exposure for a particular bank were areas identified for improvement. The EDTF recommends that the credit risk likely to arise from off-balance sheet activities be clearly disclosed.

The EDTF identified good examples of existing risk disclosures, but found banks' approaches to the same risk often differ significantly, making it hard for users to draw comparisons. The EDTF addresses the problem of comparability by recommending more disclosure around the definitions and models used by each bank, so that users can see where approaches differ. It has also collated leading examples together in the appendix to its report; this should help banks converge around similar approaches, to the extent it is relevant to their business models.

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Next steps and implications for banks

The EDTF aims to disseminate its findings widely amongst banks, investors, analysts and regulators; this paper seeks to contribute to this objective. Banks will need to review the full final report and assess what changes they can make to their 2012 reports to raise the standard of risk reporting. Some of the changes may require significant effort to implement well, and will take longer to achieve. For example, improving the quality of information about collateral may take time and could require systems changes.

Boards will need to consider whether the governance and controls they currently have over the collation and production of risk information are suitable for delivering reliable, accurate information to an external audience. The EDTF's recommendations draw out the link between financial information in the annual report and regulatory information prepared under Basel or other regulatory requirements; bringing these different sources together to give a clearer account of risk will require some careful thought, not least as they must also be consistent with the overall framework of governance and the bank's business model.

There is no requirement for the proposed new risk disclosures to be audited. For those contributing to a bank's risk reporting process, this may feel like a new source of compliance requirements. This is, however, an opportunity for banks to communicate better with stakeholders, and to demonstrate to investors the value they add through identifying and managing risk.



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