Working Group report 2007

Reform Club, London, June 21-22, 2007

This was the fourth annual meeting of the CBFR Working Group (the "Working Group", the "Group"). The event continues to be sponsored by PricewaterhouseCoopers[1] (PwC), and organised by Central Banking Publications. The meeting was chaired by Ken Sullivan, a senior expert at the International Monetary Fund. Representatives from fifteen central banks from all parts of the world were present, as were representatives from international financial institutions. The meeting was held under 'Chatham House' rules[2] and took place at the Reform Club in London, a venue which dates back to 1836.

This document is a summary of the main discussions and conclusions of the Working Group during the two days. It reflects a range of observations and views in the context of the main discussion headings and should be treated as a working document. Participants have had the opportunity to comment on this document, and their observations and suggestions are included.

[1] 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

[2] This states that participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant may be revealed. This rule encourages openness and sharing of information. See http://www.chathamhouse.org.uk/index.php?id=14 for more details.

Chairman's Summary Comments

A. Review

As the concept and indeed the reality of the independent central bank paradigm matures, issues of the nature of central bank accountability assume a sharper focus. Experience is illustrating that, within the accountability framework, stakeholders are as interested in the efficient management of central bank resources as they are in the success of the central bank in achieving the functional outcomes specified in the Law. The comment by one group participant that "the only thing that people look for in our Annual Report is the salaries of the Governor and the Board" serves as a sobering reminder that people define 'accountability' in different ways.

This fourth PwC/CBP Central Bank meeting was deliberately pitched at a higher management level than previous sessions, in order to move the debate into the Boardroom and Executive Committees. It was felt that previous sessions had already covered key areas relevant for finance and accounting managers, with focus on transparency, accounting (incl. IFRS) and financial reporting. For 2007, the group targeted deputy governors and others with broader central bank governance and risk management roles. The session agenda reflected the new focus, and covered issues of central bank capital, accountability, risk management, internal control, as well as accounting standards, external financial reporting and management information systems.

The new format appeared to work well with a high level of senior participant attendance and active involvement and contributions. At no stage did the Chair need to work to sustain the discussion. In fact, in a number of sessions participants needed to shorten presentations and discussions to remain within these and topic guidelines.

The venue was interesting and appropriate while the decision to dispense with electronic projection ensured the discussions remained collegial and reduced any disengagement by participants. The previous Chatham House rules format continues to be appropriate in stimulating contributions and discussions.

The participants reflected a mix of senior governance and managerial professionals. The presence of a communications expert added value when discussing presentation issues, and is a feature worth retaining if the topic is appropriate.

The main point to emerge from the discussions was to underline the significance and inter-connectedness of the multiple elements that form a central bank's accountability framework. In particular, one participant's introductory comments on the interaction of the risk management, strategic planning and budgeting processes stimulated an extended discussion on how the different elements of central bank organisation and administration contribute to the accountability framework. This underlines the importance of creating an overall governance framework in the bank, driven by the senior management. It also highlights the complexity of the accountability "jigsaw".

The issue of accountability for central bank administration, as opposed to functional outcomes provides a common thread for the various components. With reference to the agenda for the 2007 discussions, the only element omitted was the role of internal audit, within the governance framework. However, the presentation of one of the participants was an important factor in ensuring that subsequent discussions included this important topic with more emphasis likely on this area in future.

B. Going forward

There is a general awareness of the need for central banks to account beyond the achievement of functional goals, but central banks still lack a comprehensive accountability framework. Scope therefore exists for future Working Groups to elaborate on the general framework or specific elements within it. It will be important for the Group in future to consider the relationship with independence and autonomy; "Accountability aspects of Financial Independence." The discussions at the 2007 Working Group identified the high degree of interrelationship between the topics discussed. Any future discussion should look to try to reach a more discreet definition of the elements of central bank accountability, how they interact, and then move on with practical examples of how central bank management can achieve a broader benchmarking of practices to provide a clearer measure for behaviour and "best" practices.

The impending publication of the amended IAS 1 is likely to have important consequences for the format of central bank financial statements, the presentation of profit, distributable earnings, and retentions for reserves. Also, the new formats may present opportunities for central banks to highlight the compositions of its 'profit' to better explain why reported profits and dividends could materially diverge. Hence perhaps a future session could also look at how the amended IAS 1 will impact on reporting and accountability. This will also need to incorporate financial reporting frameworks relevant for central banks.

Also, the accountability framework could contain explicit discussion of Internal Audit and its important role in the accountability and assurance framework, the role of Audit Committees in central banks, and the differences between internal audit and operational risk management within the central bank.

Introduction to the meeting

In seeking to establish and maintain independence, there is an increasing pressure on central banks actively to demonstrate transparency in their reporting, and accountability for their actions. Ideally this would be achieved, inter alia, by the adoption of an internationally recognised reporting framework designed for all central banks to use. In the absence of a central-banking-specific framework, an increasing number of banks are looking to commercial reporting frameworks such as IFRS (or even US GAAP), or the European System of Central Banks (ESCB) guidelines.

National reporting frameworks around the world are increasingly being aligned with IFRS, with significant continued attention being paid to the closer convergence of IFRS with US GAAP. However, the essential premise of these national and international reporting frameworks is for institutions seeking to (or being required to) increase transparency and maximize shareholder value, a premise which poses particular problems for central banks for the following main reasons:

- These frameworks now require the disclosure of more complex information in the income statement. Central banks are not profit-oriented and struggle to report income appropriately: for example, large open foreign currency positions derived from reserve management activities. Their optimum risk management time horizon for managing their foreign reserves investment is more than one year so annual profit reporting captures short term volatility that may misstate medium term optimization;
- "Good losses / bad profits" – successfully achieving functional objectives may be counter-profitable and will impact the central bank results (for example, costs of sterilization to achieve price stability);
- Reporting under a commercial framework show that a central bank has negative capital, and recapitalisation will only be effective using 'real' instruments (i.e, preferably not long-dated zero-coupon government securities). Even so, 'commercial' measures of capital adequacy and solvency are of less relevance for a central bank;
- Capital maintenance may be undermined by inappropriate distributions where commercial reporting includes unrealised profits in income.
- Support operations, whether from the government to the central bank, or from the central bank to commercial banks, will be shown at real values.

Despite the difficulties, there is an increasing expectation that the central banks should be able to demonstrate effective husbandry of those assets under its control, as these are a subset of the nation's assets.

Subsequent discussions by the Group addressed the themes of governance & risk management, enhancing accountability and future challenges for the central bank finance function.

Regardless of its shareholder structure, a central bank is a "quango" (Quasi Autonomous National Governmental Organization), which has delegated authority, provided to them by government, with real power to affect peoples' lives. This is only supportable if central banks demonstrate full accountability for their performance. There are several private sector, but to date, no defined central bank-specific mechanisms or guidelines set out to achieve this. PwC will continue to explore existing governance frameworks to see if an existing model can be adapted. This is considered preferable and more time-efficient than developing a whole new framework.

Central bank accountability

Elements of accountability: Central banks' experience

The opening session discussed Central Bank Accountability:- What should a central bank be accountable for? How should it report on its accountability? What do stakeholders perceive the bank should be accountable for?

There are a number of stakeholders of a central bank, including the Finance Ministry, other government bodies, commercial banks who clear through the central bank, employees of the bank itself and the citizens of the country. Indirect stakeholders include neighbouring countries that may be impacted by any decisions. Some stakeholders are interested in task functions at a central bank, including expenses in the income statement, staff costs and depreciation. Other stakeholders are interested in the social cost of monetary policy.

Finance Ministries tend to be interested in a central bank's reserves and revenues (in particular the level of seigniorage income), and how much of that revenue the Treasury (or the State resources) will receive. Finance Ministries do not miss an opportunity to articulate that a central bank is wasteful of its income, but a central bank cannot operate effectively if it is too constrained on the choices of allocation of its income for achieving its statutory goals. Fundamentally, a central bank needs financial resources in order to put in place monetary policy. Although cost control is important, the primary function of a central bank is not to make profits - it has nonetheless to implement and maintain policies.

Elements of accountability are achieved through:

- Governance arrangements
- Internal controls
- Risk management

- Reporting framework

Central banks have not historically appreciated the value of management commentaries in financial reporting, which could be used to describe, in appropriate detail, both successes and failures. There should also be sanctions for "mis-management", with a code of conduct to hold senior bank staff accountable when something goes wrong. This would mirror the current governance requirements for executive and non-executive directors.

A participant stated that 90% of their bank's Annual Report relates to key elements of the effectiveness of the bank's monetary policy. There is a lack of focus on accounting for asset management and efficient management of resources. The Annual report often comments on the importance of ensuring that monetary policy is accurate. The report goes through structures within the bank, who the bank should report to, what the bank should do with extensive reporting of global macro-economic information and trends, banking supervision activities, and other operations. Of course this data is important for stakeholders, but there are no mechanisms in place for banks to demonstrate financial accountability. Nevertheless, stakeholders would like to know about the bank's role in controlling inflation for the citizens of that country, the conduct of its monetary policy mandate, the role of auditors (both internal and external), and the business plan to manage the assets which the bank controls.

Another participant explained how they are always under scrutiny over the cost of their operations and believes the bank is "over-audited" and over-controlled. The bank is always 'on the defensive', and has to justify its operations and efficiency, with a strong focus on costs. One feature of the excessive review and control of costs is the creation of a "blame culture" of management, restricting their use of professional skill and judgement. This particular bank's Report also includes a communication strategy to explain the reporting of the financial aspects of the bank.

Other participants commented that the balance between internal governance (risk management, internal control) and external mechanisms (audit reports) is difficult to manage. Another participant stated that there is an important balance to maintain, without creating a perception of any conflict between monetary policy and financial independence. It was felt that operational expenditures are the 'Achilles heel' of independent monetary policy, primarily because these are often most scrutinised and challenged by stakeholders.

Another participant bank has put into place performance measurements for different parts of the central banking business. The bank also benchmarks itself against a selection of other central banks with similar operations. Benchmarking allows a bank to identify differences, then consider whether those differences are appropriate or not. The bank needs to be clear in defining its objectives, which should closely reflect those specified in its law. It can then report sensibly on performance against those objectives, and be clear about the cost of achieving them.

External pressure on central bank governance and accountability

This session discussed some of the external private sector governance and accountability initiatives, and how these might be relevant for a central bank as a guide to adopting improved governance practices.

"Corporate Governance" in its technical form principally comprises the rules and practices that define the relationship between the managers and shareholders of corporations, as well as other stakeholders, like employees and creditors. Through this relationship, corporate governance helps to underpin market confidence, financial market integrity and economic efficiency; through providing an objective measurement criterion for benchmarking of institutional structures, helping to improve legal, institutional, and regulatory frameworks. A governance agenda also incorporates risk management, organisation structures, internal controls and financial management. In addition, good governance supports enhanced transparency.

Good governance is therefore fundamentally about:

- communicating stewardship and performance;
- addressing failures – for example, poor information flows, bad communications and inadequate understanding of risk;

- improving the quality and structure of management at all levels of an entity;
- making the best use of an entity's assets and intellectual capital; and
- understanding and managing risk;

There are a number of external influences and market information sources to assist a central bank in its focus on corporate governance, including the following:

- Corporate governance – the OECD principles;
- Codes of director/Board responsibilities, including stewardship;
- Transparency in financial reporting, in particular, IFRS, in order to provide a better understanding to users;
- Sarbanes Oxley rules, including financial reporting controls, with linked emphasis (not a SIX requirement) on efficiency through business process re-engineering;
- Capital maintenance – the importance of transaction & risk reporting;
- Enterprise-wide risk management; and
- Focus on the role of Internal Audit as an important assurance provider in a risk framework.

Central banks are very different to commercial banks in several ways. One key area of difference is the primary focus of commercial banks on shareholder value and profit. A central bank is not primarily in business to make money or profit, although its monopolistic role in currency and deposit requirements provide it with seigniorage income to offset against its expenditure. However, losses do happen as part of its activities, either through market movements or as a result of financial support activities with currency or the wider financial system.

A participant described the Board of directors at their central bank, stating that the Board recognise their own responsibilities, and they bring to the role their own experience in driving developments at the bank, managing risk and improving transparency.

Another participant spoke of the challenges that a central bank faces when dealing with the audit profession. There is increased guidance and regulation for auditors with new International Standards on Auditing, and auditor regulation which provide stricter rules on auditors' work and reporting obligations. Auditors are therefore now more careful and more detailed in their reviews.

Another participant mentioned bank auditor rotation requirements, the need (often prescribed in the central bank Law) to change auditors every 5 years. For those banks who wish to appoint one of the "Big 4" global audit firms, this leaves the bank with a choice of 3 audit firms only at the point of rotation (two for a joint audit). It was mentioned by one participant that it is equally important to review auditor appointment on a regular basis, and perhaps retain the existing auditor rather than force a change through rotation. Such a review can achieve both an assessment of audit service as well as avoiding the disruption and expense of an audit tender process. An alternative to audit firm rotation is a rotation of audit partner within the same firm.

In the corporate world IFRS was created, inter alia, to enhance transparency. For a commercial bank, the implementation of IFRS appears to have had a number of significant benefits. However, for a central bank, a number of the principles within certain standards (particularly relating to fair values, provisioning for losses and the treatment of unrealised foreign exchange movements), provide a complex challenge as the outcomes are poorly aligned to the central bank's objectives. It was suggested that commercial accounting standards are good as a reference point for central banks, who need to move with the market developments. However, government also need to follow commercial accounting standards for their own reporting, to provide a platform for wider use of the accounting framework. IFRS has become increasingly complicated, (in particular related to hedge accounting), but some participants felt that, from their observations it has not fully delivered the better quality communication with stakeholders which was envisaged. The ideal central banking accounting framework, which provides a consistent and relevant presentation of the specific activities of a central bank, is yet to be created.

Central bank capital

Appropriate levels of capital provide a central bank with a suitable degree of financial autonomy, which is critical to

enable the bank to perform its functions. It needs the ability to pursue its policy objectives without being constrained by financial concerns of balance sheet or income statement. Policy actions that are justified on public interest or financial stability grounds may adversely impact central bank revenue, and even result in losses.

Thus, sufficient levels of capital provide a foundation for financial independence, as well as acting as a "buffer" for the financial risks that the central bank has to bear.

This session discussed a much talked about central banking topic: what is the appropriate level of capital a central bank should hold? Is it appropriate for a central bank to have negative capital?

There is an opportunity cost involved to holding capital. A central bank should justify and account for the level of capital it holds. Losses typically arise from external factors (e.g. exchange rate revaluation) or monetary policy intervention. Sufficient losses will lead to negative capital; and inadequate recapitalisation from government will tend to lead to further losses. Central bank losses allow politicians to attack central bank policy stances, and recapitalisation takes a long time, during which period the central bank may not operate effectively in achieving its policy objectives.

A central bank with inadequate capital runs a reputational risk. Markets will require a higher premium from a central bank with perceived repayment difficulties. Recapitalisation procedures should be clearly defined in the central banking law; otherwise the independence of the central bank is undermined.

IMF guidelines state that a central bank should not have negative capital. Stakeholders should not be surprised by central bank losses. The bank should anticipate and explain why losses have or will arise, and have the right to reasonably require more capital from government to ensure future ability to achieve its functional objectives.

Overall, participants supported the idea that capital is a fundamental aspect of the central banks' role, and unrealised gains should not be transferred to government, but maintained as a buffer for future strategic actions.

However, this is a very large and complicated topic for central banks and their stakeholders. PwC agreed to develop further thinking in this area and share with the Group.

Risk management and internal control

Organising the risk management function: strategic planning

The next session covered the organisation of a central bank risk management function, focusing the discussion on strategic planning for risk management. Central banks face broadly the same market and financial risks as a commercial organisation. Although the same instruments may be traded, the transactions are often undertaken for different reasons, and in different quantities. By contrast, the operational risks faced by a central bank derive from its objectives and functions, and in consequence may be very different to those of a commercial organisation. For example, communication (or miscommunication) with the market would be a key operational risk for most central and commercial banks.

A central bank has various risk elements, summarised as:

- Strategic risk,
- Operational risk
- Financial risk (including market, credit & liquidity risk); and
- Business risk.

All of these feed directly into reputational risk, underlining the strategic importance to the bank and the markets of its actions. A central bank is assumed to have all of the ultimate powers (including, usually, lender of last resort), in order to prevent instability in the financial system, financial loss and possible damage to its reputation.

The lead speaker described the risk management process at their bank, which is integrated with regular internal and external reporting procedures. The bank has a top down approach to the organisation of the risk management function. The Risk Management framework and procedures are all linked to the overall culture of the institution, which is control and risk conscious.

The bank measures its success at each business unit, which prepares its own risk map and devises its own plans and areas of corporate risk management, and consequently are able to plan their desired outcome. This is integrated into the bank-wide risk framework, and does however require investment. Investment is usually in the form of IT systems or human resources.

The internal audit department at the bank has its own programme, reviews different areas of risk, and has its own risk management authority. This should be closely linked to the bank's overall risk and assurance framework.

There was discussion whether risk" should be "net risk" (i.e. after mitigation efforts) or "Gross risk". Another speaker described the "bottom up" approach to the risk management function as the bank looks at net risk as well as gross risk, considering the effectiveness of controls. The bank takes ownership on things that have gone wrong, and has a risk database and a business risk committee, which looks at process and reports. The participant stated that understanding of risk has evolved and people now talk about risk in a more structured way. The bank has a risk assessment spreadsheet and a corporate risk score card. A risk report is provided to the Board of directors.

It was suggested that a focus on detail led to the identification of too many key risks, and a 'box-ticking' mentality. The bottom up approach was useful as a learning process, and enabled the bank to initially understand and document the risk, but a top-down approach was needed for on-going management. Most agreed with this principle.

Incident management databases are only as good as the data put into them, and there was a cultural resistance to admitting failings and 'near misses'. The process is important but should not get in the way of the outcome. The desired outcome was to make employees aware of risks, and buy into a reporting process that enables effective reporting to management and stakeholders.

Risk management and financial reporting

The main speaker described the developments in the governance structure in their bank. 2007 has seen the introduction of an Audit Committee and an Internal Audit Department, reporting to the Board, as well as the appointment of external auditors for the first time. The Audit Committee includes independent members from outside the bank, but the number of people able and willing, with the right qualifications to take the posts is limited. The Audit Committee structure provides a high level process for risk management but day-to-day responsibility for the operation of risk management remains with the business units. Participants observed that many central banks follow the commercial practice of having a centralised risk management process, with suitable reporting and oversight by the Board and an group of independent specialists – Audit Committee, Supervisory Board, etc.

A "balanced scorecard" approach to key performance indicators is used, and could be reported externally. In any event the risk management framework should be reported externally. Risk management processes are originated to give comfort to management, but can equally give comfort to external stakeholders.

One key element of risk management, business continuity planning, needs to cover not just the prevention of threats, but processes in place to deal with the realisation of those threats – for example the liquidity failure immediately post 9/11. This BCP structure and process also needs to distinguish carefully between the central bank's own risk management, on the one hand, and its role in the market. BCP should be an integral part of risk management planning, but due to its nature, may not require regular monitoring and reporting in the same way as other risk management activities.

Internal control: the impact of Sarbanes-Oxley

This session covered the US's Sarbanes Oxley Act ('SOX') which was introduced as a response to a number of corporate scandals in the US. These scandals, primarily linked to financial risk and reporting, resulted in a significant decline of public trust in accounting and reporting practices. The Act requires US public listed

companies (both Securities and Exchange Commission registrants and Foreign Private Issuers) to identify, assess and test the effectiveness of key controls over financial reporting against the "COSO"[3] internal control effectiveness methodology.

The speaker described their bank's experience of SOX implementation. The bank undertook SOX compliance using guidance from PCAOB[4] AS2 (Auditing standard number 2; An Audit of Internal Control Over Financial Reporting Performed in conjunction with An Audit of Financial Statements). The bank employed external auditors to provide the bank with an opinion on internal controls.

The bank found SOX implementation costly primarily through own staff time spent on:

- Documentation of processes;
- Identification of key controls;
- Selection of who was to test the controls;
- Creation of test strategy of how to test the control; and
- Resolving issues that arose.

Nevertheless, the advantages of SOX implementation at the bank included:

- Enhanced transparency in overall internal and external communication;
- Knowledge, energy and engagement of accounting staff has improved;
- Ownership and accountability for internal control now sits with management as opposed to internal audit;
- There is more discussion of the financial statements in the Audit Committee;
- Better understanding of controls;
- Process documentation is a wonderful training tool;
- The year end audit is much smoother because controls testing is done earlier; and
- Audit issues get resolved earlier.

Going forward, the bank faces the implementation of AS5, which will bring its own challenges - in particular for the IT division and the remediation of deficient controls. At present the bank keeps a log of control breakdowns and remediation testing is performed throughout the year.

Euro SOX was mentioned by another participant. This is an EU directive similar to SOX in the US but the European equivalent. Potentially in the future central banks may implement a lighter version of SOX. This is significant for the European banks if Euro SOX is implemented. At present it is envisaged that the initial rigours of Sarbanes Oxley will be eased, following the implementation of AS5.

Transparent reporting

Accounting standards implementation (IFRS)

This session dealt with issues for a central bank implementing IFRS. IFRS has been discussed in some depth in previous meetings of the Group, so the speaker focussed on two areas of particular relevance to central banks: gold and distributions; as well as IFRS 7 (Financial Instruments: Disclosure"), which is a new standard with effect from 1 January 2007, and may pose particular problems for all institutions.

Reference was made in passing to IAS 21, which requires all FX movements - realised and unrealised - to be taken through income (even if price movements on the related asset are taken to reserves). This inevitably leads to greater volatility, and may in consequence lead to distribution of unrealised gains. Central bank distributions are typically asymmetric (profits are distributed to government, losses are not recovered from government) so volatility in reported profits is risks a net outflow of capital from the central bank.

A handout was provided containing examples of a central bank management commentary, accounting policy, primary statements & note disclosure for the areas to be considered.

[3] Committee of Sponsoring Organizations.

[4] Public Company Accounting Oversight Board.

Gold

Gold is not a financial instrument according to IFRS, it is a commodity (IAS39 IG B.1). However, this interpretation is not considered appropriate to a Central Bank's use of gold. Central banks are not retailers, buying and selling a stock of gold in order to make a profit: gold at a central bank is reserve asset / currency – and as such is not covered by existing IFRS standards. It is therefore incumbent on central banks to devise an appropriate accounting treatment.

The suggested treatment discussed by the Group is that gold should be remeasured to fair value, with gains and losses taken to income. Adjustment should be made in a distribution statement to remove unrealised gains from distributable profit.

Appropriate disclosure should be made in the accounting policies & notes. Fair value can be determined from the London price fixing, with adjustment made if appropriate for the cost of bringing gold holdings to international bullion standards.

Distribution statement

The practice of providing a distribution statement as a separate 'Primary' statement has been used by the Reserve Bank of Australia for a number of years, and retained following their move to (Australian Equivalent) IFRS. The statement shows profit as reported in the Income Statement, with the adjustments necessary to arrive at profit available for distribution. This provides a mechanism to disconnect accounting treatment from distribution policy.

This approach offers two benefits. It protects central banks from asymmetric distributions and consequent capital erosion. This approach is consistent with the principles underlying ESCB guidelines, which take unrealised losses to income but retain unrealised gains in reserves. Also, not distributing unrealized gains avoids any conflicts with monetary policy settings.

As with all accounting policies, appropriate disclosure is required to explain the treatment of unrealised gains / losses and the basis for calculating distributions..

IFRS 7

IFRS 7, "Financial Instruments: Disclosures" replaces and enhances the disclosure requirements currently in IAS 30/32. These now include reporting on risk management activity and actual risk exposures in the period.

Qualitative disclosures are required by way of an explanation or commentary to describe the various exposures to risk and how they arise, as well as the bank's objectives, policies and processes for managing the risk and the methods used to measure the risk.

This provides an opportunity for a central bank to explain, for example: the differences between 'normal' operations and monetary policy intervention; the credit risk implications of standing as lender of last resort; and the bank's use of derivatives.

In addition to the qualitative commentary, there is a requirement to include quantitive analysis (e.g. VaR) and sensitivity analysis.

There is a requirement to provide commentary on capital resources (IAS 1 p124A). This will include a commentary on how capital is accumulated and distributed; explain how capital is managed; and explain the principles of how the central bank determines the appropriate level of capital.

There are no significant changes to accounting policy disclosures. Quantitative risk disclosures are required. These include liquidity, interest rate & currency mismatch tables (as IAS 30/32), but more information is required on credit risk, especially credit quality, collateral and impairment.

IFRS questions

Gold:

- How do you treat gold currently?
- Is it appropriate to remeasure to market value?
- Is it appropriate to take gains/losses to income?
- Should unrealised net gains be distributable?
- Is the suggested treatment 'allowed' under IFRS?

Distribution Statement:

- Is this useful?
- How easy is it to put into practice?
- What are the risks, or opportunities of being more explicit?

IFRS 7 challenges:

- Could you prepare the information?
- Would you be happy to disclose the information?
- What are the risks, or opportunities of being more explicit than before?
- Would this contravene any bank secrecy laws?
- Would disclosure undermine the central bank's effectiveness in implementing monetary policy?

Subsequent discussion included comments that, whilst the fair value concept within IFRS was expected to and indeed has increased volatility in reported earnings, nonetheless a distribution statement was preferable to taking fair value changes to equity, and would not change the bank's overall distribution policy.

Central banks should be proactive in making disclosures in line with new IFRS requirements, for example, for sensitivity analyses and reporting of operational risks (although there's still a question around how much to disclose). Disclosure of credit risks arising from the central bank's support operations within the general banking system, may be awkward to disclose, but would not undermine the bank's essential functions.

There was widespread support for the distribution statement as a means of making IFRS a practical option for central banks. The increasing disclosure requirements of IFRS were not seen as a barrier to adoption.

Multiple-standard implementation (ESCB/national)

This session focussed on the application of ESCB guidelines alongside existing national reporting rules. One comment was that if ESCB rules had been determined ten years later, they would have simply adopted IFRS, but with a distribution statement to restrict distribution of unrealised gains. At the time, the European Monetary Institute (predecessor organisation to the European Central Bank 'ECB') considered the various elements of accounting and reporting, including transparency and prudence, and concluded that prudence was the overriding concern. This led to the asymmetric treatment adopted by the ESCB, whereby unrealised gains are taken to a liability reserve, but unrealised losses, in excess of any reserve, are charged to profit. It was explained that the profit distribution mechanism was outside the scope of the accounting framework, so the framework itself was designed to achieve de-facto control over inappropriate distributions by preventing the recognition of unrealised profits.

The effect is the same as full recognition of gains and losses (i.e. IFRS) with a distribution statement to restrict distribution of unrealised gains; but the presentation and disclosure are different.

ESCB guidelines aim to achieve a 'harmonised approach' to reporting by central banks, but this is not complete, and differences arise between institutions; particularly in the treatment of other assets & liabilities, derivatives and other 'new' instruments. For example, ESCB treatment of an asset swap derivative, which perfectly matches gains and losses, would nevertheless only allow losses to be recorded in the income statement, leading to repeated losses year after year. This would not reflect the economic reality.

ESCB guidelines do not cover every eventuality, so IFRS is recommended (required for the ECB itself) in all other areas. This means that all the new areas of IFRS such as management commentary are being introduced to the ECB's reporting.

Performance measurement/reporting costs of functions

The lead speaker for this session described their bank's implementation of a 'Cost and management information system'. This was intended to improve efficiency by focussing not only on the achievement of main objectives, but the way those objectives are achieved.

The bank used a consulting firm to develop the framework and adopted a 'bottom up' approach to recording functional costs. The system checks efficiency, checks cost effectiveness of the delivery process, looks into the administration cost of policies, goals and missions at the central bank, and monitors cost objectives of central bank. Cost objectives are accounted for at the end of each

accounting period, through the financial system which is then reported to the Ministry of Finance.

Outputs produced from the system:

- Monthly cost bulletin
- Measure major functions in terms of usage
- Billing for external work
- Income statement presented on a functional basis

The bank found that 60% of resources are spent in core functions. The system allows better pricing of services to government and commercial banks, and benchmarking the cost of similar services provided by two or more areas within the bank. The results derive from the system are published monthly through internal communications. The bank is in the process of developing an external communications framework.

Next steps for the bank: improve the quality of cost drivers, find ways of using the system better and use the system to support decisions made in relation to central bank policy implementation. Longer term the bank would like to introduce external benchmarking.

Another participant informed the group that their bank also publishes its budget information and cost information. Other participants contributed that their bank give full functional cost disclosure and another bank added their bank uses monthly surveys to ensure they are not over controlled.

Functional costing systems can improve efficiency, and also enable better communication about efficiency to stakeholders. What gets measured gets done; and measuring costs saves costs: experience shows an increased awareness of how individual activity contributes to cost objectives, resulting in more application by individuals. Four years ago only a couple of banks had considered cost of functions now more central banks are considering the benefits of cost of functions.

The limitations of the income statement: the need for additional reporting

This session discussed the concept of a management commentary that the central bank could provide beyond the income statement. Management commentary can be known as MD&A - management discussion and analysis, OFR – operating and financial review or MR – management reporting.

Different central banks disclose different information, but what is appropriate? Should there be guidance/best practice solutions to advise central banks what to disclose? If such guidelines existed would central banks adopt these? Could such additional reporting be best kept in another part of the annual report as opposed to management commentary on the financial statements?

Central banks are accountable to the public for how it manages their funds as the bank is utilising public funds (i.e., taxpayers' money). Hence, citizens have a legitimate interest in a central bank's accounts.

A participant informed the group that their bank is under pressure to disclose salary details of top management, the bank instead provides an explanation for the system for compensation and bonuses. Another participant added that their management commentary explains the budget process but not actual budget figures, although another bank does publish a budget for the forthcoming year. Another participant informed the group that the stakeholders were interested in how much is spent on communication.

It was generally felt that there is limited scope for standardised/rule-based management commentary due to the uniqueness of a central bank. There is perhaps a danger in explaining sensitivity analyses (especially forward looking measures) if this could impair the ability of central banks in pursuing and achieving their primary objectives.

Additional reporting provides an opportunity to explain the unique activities of the central bank to stakeholders. A central bank's Annual Report is different to a commercial organisation's report as the bank is not a profit making organisation and should be measured firstly on the

effectiveness of achieving its core objectives, in particular, implementing and maintaining policy. Central banks face a wider spectrum of risks then typical commercial entities, and should be proactive and forward looking in explaining this, going beyond the disclosures required by IFRS.

Managing the entire accountability framework

All participants felt that the meeting had served its primary purposes – to enable senior central bankers to discuss the key issues of the day. It was agreed that all central banks face a number of difficult challenges, from, amongst others:

- Stakeholders, particularly Parliament - requiring more information and transparency, and dividends!
- Clients, both government and commercial banks - wanting more services for less money and comparing central bank provision to the commercial sector
- Markets - constantly changing and developing, with continued volatility
- Standards and policies - reporting standards which apply directly to the institution, and auditing standards
- Technology – complicated, expensive and difficult to implement
- Staff - these challenges and changes have inherent psychological and social factors, with greater emphasis acquired on staff training and overall competence. People are the main capital of the bank.

These in turn pose a challenge to the Working Group, to promote and share experience and best practice solutions as the central banking world continues to develop. Overall, it was felt that the discussions in the Group this year were very positive, demonstrating that overall, central banks are carefully identifying and facing up to the increasing number of challenges, developing their own methodologies or adapting those available in the private sector, in order to improve operations, monitor and manage risk more effectively, and report their activities in a more coherent, consistent and transparent way.

The Group remains committed to providing a discussion forum for identifying best practices, and for moving the debate forward with the wider central bank community. This should help to ensure that an increasing number of central banks benefit from the initiatives noted within the Group.

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