

# Central bank Financial Reporting Study Group 2008

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*Note of the meeting prepared and edited by  
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This was the fifth annual meeting of the study group. As in previous years, the event was sponsored by PricewaterhouseCoopers, and organised by central banking Publications. The meeting was chaired by Kenneth Sullivan, of the International Monetary Fund. Representatives from sixteen 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<sup>1</sup> and took place at the Reform Club which dates back to 1836.

This document is a summary of the main discussions and conclusions of the study 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.

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<sup>1</sup> 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 Comments

## A. Review

This study group set itself the task of discussing the elements of central bank financial independence and how it related to performance. The six months from the Study Group in May to the publication of this summary has been tumultuous. The twin problems of stagflation and recession that appeared to be the most likely challenges then, have morphed into the most fundamental challenge to global financial stability and central bank efficacy of our professional lives. On both national and global levels central banks face challenges of financial system stability, exchange rate volatility, and the deflationary effects of the recession. The crisis has placed the assumptions of central bank independence and accountability, along with their component parts of capital adequacy, financial independence, and transparent reporting under the most intense scrutiny. For many central banks, the contingent liabilities of lender of last resort and systemic liquidity provision are manifesting themselves on the balance sheet. Issues of collateral quality, asset impairment, and valuation are creating challenges for financial reporting. Transparency of reporting and systemic stability issues in some case seem to present conflicting challenges and, increasingly, central bank capital matters.

While it may appear that events have eclipsed aspects of contributions, including my own, it is reassuring how much remains relevant, and in many instances is reinforced by recent events. As the level of public resources under central bank management and potentially at risk grow, the importance of explaining performance to the stakeholders increases. Challenges to central bank independence and accountability remain.

## B. Going forward

Besides the policy challenges posed by the crisis, central banks need to not only develop the appropriate measures to manage the resources under their control but also be able to report this stewardship to the stakeholders. This involves extending the performance reporting framework beyond financial statements prepared under an internationally recognized framework to include relating the use of resources to the discharge of those functions the central bank is charged to perform.

# Introduction to the meeting

The role of the central bank has changed and from the emergence of the global credit crunch, we will be seeing a demanding period for central bankers. It is only after the credit crunch that we will be able to see the fruits of our labour and how strong the frameworks are in which central banks monetary policy, governance, and financial supervision are grounded.

Central banks face three challenges over the coming period: the impact the dollar weakness has on the domestic currency; economic recession; and how central banks maintain independence during this difficult period.

As adoption of IFRS becomes more geographically widespread, central banks need to ensure that their own reporting provides sufficient information, and explanation of their activities, to demonstrate their financial responsibility.

## Central banking independence and demands for greater transparency

Central banks must be transparent to maintain independence. By disclosing costs by function, and explaining the impact of economic/monetary policy on those costs; both now and in the future; a central bank can demonstrate greater transparency and thereby help to preserve its independence.

This cost by function accounting information includes central distributed costs such as IT and HR. In some countries the analysis receives high attention from senior management and is given to the Minister of Finance and is well received within government. Analysis is useful, in particular for budget setting and objective setting but there is a risk of over analysis and losing the bigger picture in the detail. For example, central costs may seem reasonable in the context of each individual function, but not when viewed in total.

Comparisons can be made with other central banks but with a clear understanding of any differences between comparator central banks. It is acknowledged that this comparison can be difficult, but remains a valid way of generating ideas for cutting costs. An example would be that if a central bank saw administrative costs down by 10% in several other central banks, then it may want to look at what it was doing differently and how it could be made more effective. Comparison may provoke negative comment, which could be difficult to rebut. An alternative would be to publish a comparison of actual v budgeted cost. This could perhaps be done on a website rather than in the annual report.

Analysis of cost by function is not necessary, but can be useful in establishing the cost of a service for on-charging to the government or commercial banks. Greater analysis is likely to be demanded when there is pressure to restrict or reduce costs: however starting before the bad times arise, gives a longer time series to provide a better overall picture.

## Independence in the context of liquidity support operations

Central banks have been providing unprecedented levels of additional liquidity during the credit crunch. Demand from the commercial banks seems limited only by the availability of suitable collateral; with a premium offered for longer term facilities. One concern for central banks is that the additional liquidity this creates could endanger inflation targets. Issuing Treasury securities against collateral can help financial stability without increasing liquidity; but not all central banks have that facility available.

central banks need to be wary of the type of collateral they are prepared to take as there is a risk of commercial banks 'offloading' poor quality assets to the central bank. Indeed, commercial banks are creating packaged instruments specifically for the central bank repo market. That is not to say poor quality assets cannot be accepted as central banks need to be flexible enough to inject liquidity as and when required. In such times it may be necessary to increase the nominal value of collateral demanded (to compensate for the perceived loss of quality); however the central bank should be aware of the additional credit risk in accepting illiquid assets. Risk management limits should still be applied, though under current market conditions difficulties exist in assessing the value of the collateral provided.

Practical difficulties arise. One central bank can only relax its collateral rules after declaring the current market situation a “crisis” – something it is reluctant to do. Another central bank is trying to take liquidity out of the market by issuing treasury bonds; however they haven’t got enough bonds to sell. The central bank also has to pay interest on these bonds.

## The impact of shifting collateral frameworks on the balance sheet

A fundamental rule within all central banks frameworks should be never to lend without collateral.

Risk Management criteria should include two 3rd party credit ratings for collateral. As the quality of collateral declines a central bank needs to have more stringent valuations on the collateral it accepts. During this difficult period, central banks will need to be more flexible with the type of collateral accepted, but need to avoid taking poor quality assets.

One prime central bank role is to control inflation by injecting or withdrawing liquidity and/or adjusting interest rates. However, as recently seen, this doesn’t work when market rates diverge from the official rate. Ultimately though, central banks will always provide liquidity to a significant financial institution because, whilst the cost of bailing them out is high, the costs of a systemic failure can be much higher.

## Keynote Discussion: “Defining Elements of central bank Financial Independence”

Independence demands accountability and transparency. Financial independence is one key factor and requires adequate balance sheet structure and earnings to support it. Financial independence implies the right to determine the budget, specific accounting rules and well-defined rules regarding the transfer of profits. It fosters credibility, the ability to withstand political pressure, and leeway to make unpopular decisions. Crucially, financial independence enables the bank to avoid procyclical investment behaviour.

Independence directly contributes to achieving monetary policy targets such as stable interest rates. Central banks also need to convey a certain image when financial or governance arrangements are configured. A test of financial independence should be the ability of a 3rd party to come in and assess the performance of the central bank.

A central bank’s earnings derive from seigniorage and invested capital. Those earnings can then be applied to cover operational costs, to accumulate reserves and to transfer surplus profits back to government. In some cases Government are given the same amount each year due to a dividend equalization reserve which a bank applies during the good and bad years. This improves the ability of government to budget their own revenues. Determining the appropriate level for this provision should cover more than one political term.

Foreign currency reserves are needed for intervention, to prevent and overcome potential crises and to build confidence. High currency reserves allow the central bank more scope when market intervention is necessary but this requires more capital. Determining the appropriate level is more an art than a science, but will be informed by factors such as GDP, import values, the level of short-term foreign debt in the central bank, and aggregate foreign liabilities in the banking sector.

## The unique nature of central bank capital

Historically central banks were assumed to be profitable, and would accumulate capital through seigniorage rights, though this is no longer obviously the case. Central bank capital is not the focus of attention - policy effectiveness may be considered more important – nevertheless a central bank’s balance sheet shows the outcome of its diverse responsibilities and reflects the development of the national economy.

Central banks need to maintain adequate capital in order to preserve financial independence, and the benefits of seigniorage rights may be offset by contingent liabilities such as lender of last resort, deposit protection and exchange guarantees.

Losses arise from revaluation of foreign currency and operational losses (sterilisation/monetary policy), and although a central bank can function on negative capital, implicit government support will depend on the overall fiscal position. Losses limit independence and the ability to absorb further losses into the future. Relying on the government may be okay when times are good, but there is no guarantee they can/will support in the future.

Capital is also very important for the reputation of the central bank and its overall creditability. It may survive with negative capital as long as this is only arising from currency revaluation, but would not be able to withstand operational losses from monetary policy intervention which directly impact liquidity. Losses from revaluation of foreign currencies may not impact creditability because they show that the domestic currency is strong.

Giving government a predictable and stable stream of income requires the central bank to either adjust controllable provisions to achieve profit smoothing or maintain a dividend equalization reserve. Adequate capital implies the ability to produce net profits and realised earnings year after year whilst having positive capital to cover the risk inherent in operations.

## Identifying risks and who should manage them

New auditing standards (such as AS5 in the US) require increased management involvement in controls testing and assessment of risk. Management are responsible for controls and testing but may involve internal audit in regular assessments. The focus on controls testing has led to closer management involvement in business processes and controls design. This has improved management understanding of the controls framework. Processes to identify risks, document controls and test those controls have become embedded – both for financial and operational risks. As a result control deficiencies identified by the external audit have been largely eliminated.

Suggested improvements include: focussing on key risks only; standardising risk and controls documentation; greater management involvement; improved processes for assessing risk; and use of automated controls where possible.

Each operational area should have a risk management function, but some form of integrated risk management is needed at the whole bank level to fully understand the correlations and interdependencies between different risks.

## The effect of reserves management on capital

Capital is required to cover risks; foreign currency exposure is the most significant balance sheet risk but a level of short term foreign currency reserve assets is necessary to provide liquidity. Any surplus capital can be invested into funds to optimise revenues. High revenues come with high risks and longer investments (restricted liquidity) which may be inappropriate to a central bank. Increasingly we are seeing assets in excess of liquid reserve requirements transferred to sovereign wealth funds. Removing surplus reserve assets from the central bank balance sheet can help to reduce volatility.

## The impact of exchange-rate volatility on capital

A number of central banks, particularly in developing economies, have been making regular losses for the past number of years. Despite the massive losses, there still is a high level of operational independence from government (set own inflation target etc), however this cannot be maintained as direct government support would constrict independence.

It is necessary to consider the origin of these losses; a developing economy implies strong growth but at a risk premium. The main factor for losses is the appreciation of the exchange rate, reflecting high levels of net foreign investment which in turn puts pressure on the domestic rate of inflation that offsets the gains from currency appreciation. As a result it may be necessary to raise the target inflation band. For a central bank, the corresponding depreciation of foreign exchange

reserves results in significant unrealised losses in domestic currency terms, which exceed the profits derived from domestic operations. These central banks may be able to settle accumulated losses from future profits over a number of years, once their economies (and currencies) converge with those of developed countries.

To some extent this may be driven by accounting. Even where the accounting practice is to take unrealised losses to reserves, realised gains/loss in P&L may be distributed to government. Unrealised losses impact on independence especially when requiring recapitalisation although this still does not impact on monetary policy.

One view proposed is that a central bank should adopt full IFRS, which recognises all gains and losses through P&L, but additional steps are required to base the distribution of income (either to reserves or to government) on realized profits. Hiding unrealised gains is counter-productive in the long term, although some central banks would be forced to distribute recognised gains under existing legal arrangements.

## The effects of implementation of IFRS 7 (and IAS 1 amendment on capital)

### Financial instruments - credit risk

IFRS 7 requires an explanation of the significance of financial instruments for an entity's financial position and performance, intended to provide an overview of the entity's use of financial instruments and the exposures to risks they create. However some of these disclosures may prove difficult, or inappropriate, for a central bank. Central banks typically hold assets which are not externally rated. This may be because they are too good to need it (e.g. Gold, IFIs & UK / US treasury bills) or perhaps because too small (or too risky) to warrant getting one. Where government debt or securities are unrated it may be appropriate to use sovereign ratings of the country as a proxy. However in all cases where external ratings are not available, the bank will need to provide alternative information.

For financial assets that are past due or impaired, the standard requires a description, and valuation, of collateral held. Given the liquidity support that central banks are currently providing, there may be significant balances which are overdue or impaired; and some difficulty in describing and fair valuing the underlying collateral provided by the borrowers.

The standard requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. Maximum exposure to credit risk will exceed balance sheet value where there are guarantees, contractual payments, or off balance sheet commitments and contingencies. This will require central banks to quantify and disclose guarantees and commitments under financial stability, lender of last resort or deposit protection programmes.

### Financial instruments - market risk

The standard requires a sensitivity analysis of market risk to show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period. It is not sufficient to show the impact of a nominal change (e.g. 1% or 25 basis points). However it is difficult to predict what is 'reasonably possible' and what central bank would want to disclose the probable shift in domestic interest rates over the next 12 months!

### Mis-match tables

IFRS 7 requires a maturity analysis for financial liabilities that shows the remaining contractual maturities. This replaces the requirement from IAS 30 for a bank to disclose analyses of assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. Similar disclosure was required for interest rate repricing risk and currency mis-match.

IFRS 7 has reduced requirements from IAS 30, but fuller disclosure (including the mis-match) is better. IFRS 7 does add more qualitative disclosure e.g. a description of how it manages liquidity risk.

## Fair values

The standard requires disclosure of fair values where different to the carrying amount. Differences are likely to arise on assets and liabilities carried at cost (some central banks still carry gold at cost) assets held to maturity and loans & receivables. It should be stressed that the absence of an impairment provision on loans does not mean that book value equates to fair value. Equally fixed interest assets & liabilities (including government securities) will be subject to fair value fluctuations.

## Capital – Qualitative measures

The changes to IAS 1 require entities to disclose qualitative information about the objectives, policies and processes for managing capital, including (but not limited to) a description of what it manages as capital.

Consideration of what a central bank regards as capital is a whole topic in itself (e.g. seigniorage rights). To then describe objectives and policies for managing capital the central bank needs to be able to determine what is an appropriate level of capital. There may be problems describing the policy for managing capital if distributions are prescribed by law, or if the practice includes 'smoothing', 'hidden reserves' and reserves for volatility which simply reflect the one-way nature of distributions versus recapitalisations.

## Emerging issues in the conversion to IFRS

Central banks in emerging economies face vastly different issues to those in already established economies. They have almost no income earning assets to match the note issue, with notes costing more to print than the face value in some cases (Financing from the vault). There is also the question of who should pay for the central bank, the commercial banks or the government? This raises issues of independence, how can the central bank avoid conflicts of interest if it is financed by the commercial banking sector? And if government were to financially support the central bank, then independence when setting fiscal policy could be undermined.

Advantages of conversion to IFRS include direct IMF assistance with the implementation (this may be a pre-requisite for any IMF lending), improved confidence from external donors to support the central bank and removal of worthless assets from the balance sheet which could have been included in past accounts.

Practical issues which face the emerging economies in their adoption of IFRS include:

- Identifying the functional currency – the domestic currency may not be in widespread use;
- Establishing the fair value of claims on government;
- Related party transactions (particularly accounting for IMF balances & transactions);
- Treatment of donor aid and donor assets – how to value and whether to treat as off-balance sheet;
- Cost of banknotes – write off the cost as incurred or amortise – and if so over what period?
- Risk Management – there may be no existing function, or staff lack the relevant skills
- Disclosure of salaries (which could make individuals a target)
- Pensions – difficulties in establishing a 'risk free' discount rate and calculating mortality tables – particularly when many employees will not know their own age.

The IMF position seems to be that full implementation of IFRS is advisable for a central bank for reputational reasons. There are acknowledged to be problems, but many of these are present under other standards as well. There is still interest in developing a 'central bank reporting standard' combining elements of IFRS and ESCB principles, as appropriate to a central bank's activities and function.

# Issues of transparency in the lender-of-last-resort function

In recent years “transparency” has been seen by many commentators as something of a holy grail. Indeed the word has become something of a cliché. Give market participants clear, complete and timely information (i.e. transparency) and, so the reasoning goes, the markets will make sure that transactions and assets are properly priced; economic resources are allocated in an optimal manner; misbehaviour will be punished; and, generally, all will be right with the world. And as with much to do with central banking, what was seen as good for the commercial sector was felt to be appropriate for central banks too. When the UK had the recent Northern Rock crisis it made them reconsider. Northern Rock is a mid-sized, listed UK mortgage bank with assets of around £120 billion. More than most UK banks, it relied on a high proportion of wholesale funds and it suffered difficulties following the recent disruption in the wholesale funding markets during this summer’s credit crunch.

For most of the modern banking era transparency was something of an anathema to bankers, both the commercial and the central banking varieties. After all, banking is all about borrowing short and lending long, a formula which requires a sound foundation of public confidence to survive. Any crack in that façade of confidence could cause a run on a bank with usually fatal consequences. But gradually as banks became larger and more stable and supervisors were seen to police the banking sector, then elements of transparency began to creep into the commercial banking world. An interesting example of this was the hidden reserves maintained by the UK merchant banks. Such reserves could be, and were, used to cover significant credit or other losses where disclosure might undermine confidence in the entity. Then changes in legislation in the early 1990s meant that hidden reserves became illegal and had to be revealed for the first time. When the banks finally lifted their skirts the general reaction was surprise that these hidden reserves had been so small. To some, this was proof that secrecy was an anachronism in an age when the public could be trusted to act rationally when presented with true facts. To others it was proof that hidden reserves had worked well when comparing the low level of those reserves to the levels of confidence generated over so many years. From those small beginning we now have bank financial statements which reveal full details of loan loss provisions, fair values and risk exposures. Perhaps naturally there has been a push for similar transparency in the financial statements and actions of central banks. The bank of England, while seeking to follow best reporting practices in most areas, has always maintained that it would not disclose its lender of last resort activities while a support operation was in progress. Its financial statements have long included an accounting policy to reserve the right to withhold disclosure until the need for secrecy has passed. Few other central banks have made such a clear statement of policy.

It perhaps, therefore, seems ironic that when the bank of England made facilities available to Northern Rock, the details were publicly announced. Immediately there began the first run on a UK bank for 140 years. The bank has argued that EU laws, particularly market abuse rules, given Northern Rock’s listed status, meant that a covert arrangement would have been illegal; the EU has subsequently disputed this. Maybe it also did not help that the existence of the facility was leaked by the media before the formal announcement was made.

Since the transfer of banking supervision from the bank of England into the Financial Services Authority (FSA) in 1997, the framework for dealing with bank failures has involved tripartite arrangements between the bank, the FSA and the Treasury – and Northern Rock was the first test of this arrangement. It appears that the view was taken that announcing the support arrangements would enhance market perceptions and maintain public confidence. And perhaps that is the point; while the market professionals could take comfort from the bank supporting a solvent but potentially illiquid bank, the general public rushed to get their money out. Market confidence and public confidence are not the same thing in this situation. The apparent paucity of the UK’s deposit protection scheme, which only provides 100% protection on the first £2,000 and then 90% of the next £33,000, will not have helped, but it is unclear whether the average retail customer ever knew about this scheme or its terms.

There are, no doubt, many lessons to be learned from this episode over the coming months and inquiries have already begun. It is clear that the current tripartite arrangement failed its first test and one question to ask must be: is it right to separate the lender of last resort facility from banking supervision?

One key conclusion seems to be that transparency does have its limits and greater transparency in all things is not always in the public interest. Information that professional markets can take in their stride can cause major disruption to

less savvy retail customers. While this says nothing about transparency in the generality of a central bank's operations, the conclusion must be that central bank support activities involving retail banks do not lend themselves to transparency. If the bank of England had been able to stick with its accounting policy maybe Northern Rock would still be a credible independent bank, albeit with a secret liquidity problem, or, on the other hand, given its size and the media interest, would the secret have leaked out anyway with the same result?

## Communication around financial performance

Communication is an important element in a central bank achieving transparency and accountability. Communication with the media helps manage expectations and create predictable reactions to results.

Communication around financial performance is achieved in one of two ways: direct meetings with the media or within publications. Financial performance though is not the main issue; it is about being transparent with the results. The communication officer may discuss profitability and inflation targets but is less open about foreign currency reserves. Central bank capital may be a worthwhile topic to discuss but up till now has generated little interest from journalists.

Communication officers use the following tools when explaining financial reporting:-

- Benchmarking
- IFRS disclosures
- P&L as a performance indicator
- Functional reporting – showing comparative costs
- Compare and contrast local CB's with similar activities
- Showing financial information for a specific purpose and give own interpretation.

Confusion still exists in the public perception between strong economic performance of the economy and 'bad' financial performance of the central bank. IFRS reporting is generally more forward-looking, and there is value in describing ahead of time the reasons why the central bank might report a loss in the current and future economic environment.

## Summary and Conclusions

Financial commentary does not stand alone. It can be integrated with the financial statements, or provided separately. What is important is that the central bank takes control of the process. With the worsening global economic environment we will face new and stiffer challenges. The question is whether we have laid the foundations to be able to handle this.



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