FS Regulatory Brief

The FSB pushes for enhanced risk disclosures

November 2012

Executive summary

In May 2012, the Financial Stability Board (FSB) sponsored the creation of the Enhanced Disclosure Task Force (EDTF) to establish principles, recommendations and leading practices to enhance bank risk disclosures.

The initiative originated with the FSB in response to the perceived need for improvements in the transparency and effectiveness of communication across the financial services industry, especially in the areas of business, risk and compensation models.

Starting in 2012 and 2013, the EDTF members expect to implement the proposed recommendations, which are comprehensive across six major areas. Other large international banks will also be encouraged by the FSB to adopt the recommendations.

The EDTF recommendations may influence the expectations of the SEC, FASB, IASB and Basel Committee on Banking Supervision regarding risk disclosures and could impact their respective reporting requirements in the future.

The EDTF recommendations mark a further step towards the inclusion of risk-based information in financial reporting and anticipate the need for banks to further align their risk and finance processes, particularly with regard to controls over externally reported information.

Background on EDTF risk disclosure efforts

Since the financial crisis of 2008 and 2009, regulators and standard setters have focused on enhanced risk disclosure as a key area of improvement to restore confidence in the banking industry. In this context, in December 2011, the FSB hosted a roundtable to discuss the key areas where risk disclosure practices should be enhanced.

Senior officials and experts from around the world took part in the roundtable, representing investors, analysts, asset managers, credit rating agencies, banks, insurance companies, audit firms, accounting and auditing standard setters, prudential and market authorities. At the conclusion of the roundtable, the FSB agreed to facilitate the formation of the EDTF.

Unlike previous efforts by regulatory bodies and standard setters, the EDTF recommendations resulted from the unique cooperation of private sector representatives. In particular, the EDTF was comprised of leading asset management firms, investors and analysts, global banks, credit rating agencies and external auditors from all major geographies. In addition, the EDTF held discussions with standard setting bodies and regulators in the main jurisdictions across North America, Europe and Asia, and received feedback from the Institute of International Finance and the International Banking Federation.

What was the outcome of the EDTF efforts?

On October 29, 2012, the EDTF issued a report that establishes seven fundamental principles related to risk disclosures:

- Clear, balanced and understandable;
- Comprehensive and inclusive of all of the bank's key activities and risks;
- Present relevant information;
- Reflect how the bank manages its risks;
- Consistent over time;
- Comparable among banks; and
- Provided on a timely basis.

In addition to these seven principles, the EDTF provided a set of 32 recommendations (see Appendix for details), with a focus on specific quantification in priority areas highlighted by investors, including:

- Liquidity reserve;
- Asset encumbrances and maturity gap analysis;
- Capital and risk weighted assets;
- Linkage of financial statement line items with traded and non-traded risk disclosures; and
- Flow statement of impaired or non-performing loans and allowance for loan and lease losses.

Many recommendations are supported by illustrative leading practices and examples of risk disclosures from selected banks to facilitate implementation and comparability.

The EDTF report is not prescriptive in terms of the location of risk information (e.g., annual reports, audited financial statements, separate reports, or websites). Rather, the recommendations emphasize the importance of providing timely information, in line with the financial reporting cycle of each bank. In practice, we anticipate that many banks adopting the recommendations will do so in the MD&A section of their periodic reports, or through supplemental reports similar to those required under Pillar 3 of Basel II or those which accompany current earnings announcements.

Which recommendations are incremental to existing requirements?

The EDTF recommendations are incremental to existing SEC, FASB, IFRS, Basel II / III requirements, with a few exceptions in the areas of capital, market risk and credit risk (see Figure 1).

The most significant recommendations relate to liquidity, funding, asset encumbrance, contractual maturity of financial assets and liabilities, capital, and Risk Weighted Assets (RWA - parameter information by PD band, RWA density, and reconciliation to balance sheet exposures).

An example in the area of funding is related to disclosure of contractual maturity of financial assets and liabilities. Many foreign banks do not currently provide this information and many US banks adopting this recommendation will need to categorize assets and liabilities, including off-balance sheet exposures, into more granular quarterly maturity buckets for items with maturities shorter than a year.

Figure 1. Overlap of EDTF recommendations with other disclosure requirements

Areas in red indicate EDTF recommendations that are incremental to existing and proposed disclosure requirements and guidance.

Overlap with existing disclosure requirements — High | Medium | Low

Risk Area	Basel II Pillar 3	Basel III	SEC	U.S. GAAP[1]	IFRS[2]
Risk Governance / Risk Mgmt.	Medium	Low	Low	N/A	Low
Liquidity and Funding	Low	Low	Low	Low	Medium
Capital Adequacy and RWA	Medium	Medium	Low	N/A	Low
Market Risk	Medium	Low	High	Low	Medium
Credit Risk	High	Low	Medium	High	Low
Other Risks	Medium	Low	Medium	N/A	N/A

[1] Includes FASB Exposure Draft on Financial Instruments (Topic 825): Disclosures about Liquidity Risk and Interest Rate Risk
[2] Refers to IFRS 7, Financial Instruments: Disclosures

How are large international banks impacted by the EDTF recommendations?

The work of the EDTF should help banks better understand the expectations of market participants, including key investors and funding providers, around disclosure of risk information. In addition, the EDTF effort provides banks with guidance as to the priority areas that should be addressed in terms of transparency and granularity. As this increased transparency reduces the uncertainty associated with the risk profile of adopting banks, it could potentially contribute to the reduction of valuation discounts resulting from conservative assumptions made by the analyst community.

Implementation of the recommendations will increase the reporting responsibilities of the risk function and require a higher degree of interaction between the risk and finance functions for disclosure production. This will increase the need for processes and controls over risk information, and impact the way in which certain risk data is measured and aggregated across the bank.

Almost half of the recommendations are focused on increased granularity and transparency through narrative descriptions of risk management practices and processes. Risk, finance and regulatory reporting functions will need to play an active role in describing the bank's practices and framework around, for example, stress testing, key risks arising from business activities, and policies for non-performing loans.

Disclosures that require reconciliation of RWA and other risk measures to the balance sheet will require banks' risk, accounting and regulatory capital information to be aligned, or perhaps combined, to allow for automated production.

Finally, certain disclosures will require banks to aggregate information from different geographies, business units and legal entities, such as those disclosures pertaining limitations on the use of liquidity maintained within material subsidiaries. This will prove challenging for banks which are operated as a series of relatively autonomous business units rather than as one consolidated entity.

Beyond the effort required for the production of new disclosures, banks will need controls to ensure the accuracy and quality of risk information made available to external stakeholders. Many banks have begun to align their risk, regulatory and financial information processes in response to regulatory and other demands, which will be helpful in responding to the EDTF recommendations.

How should banks respond to the EDTF recommendations?

In developing their response, banks should prioritize adopting those recommendations that will provide the most value in terms of added transparency with a moderate level of effort, including presentation and qualitative disclosures. While certain quantitative disclosures may be more time- and resource-intensive, banks can look to prioritize the implementation of those recommendations that can be addressed through minor modifications and increased granularity to existing disclosures (see Figure 2).

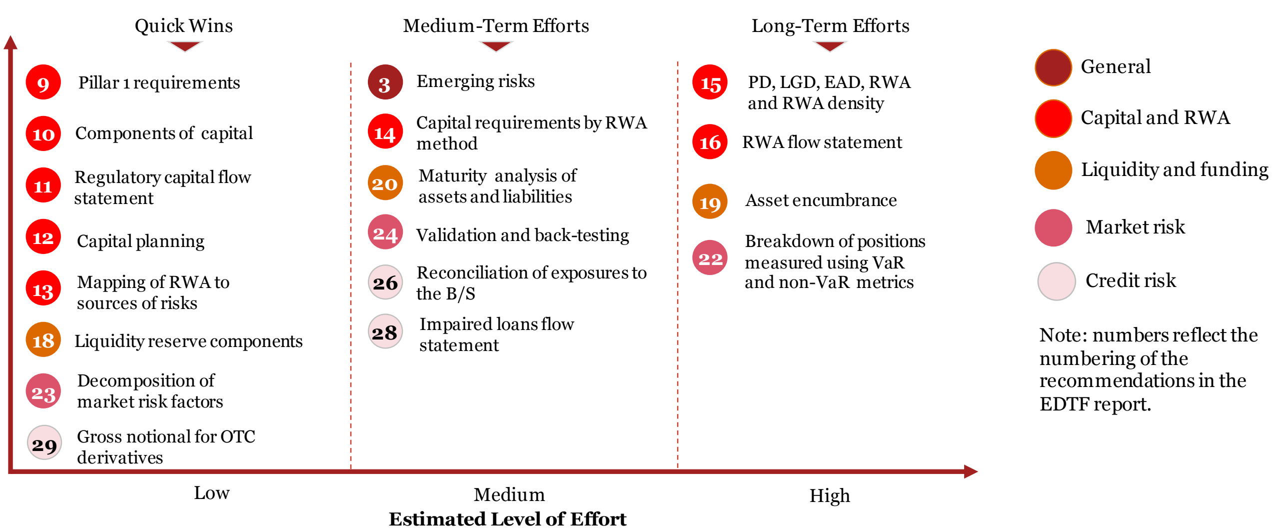
The EDTF recognizes that some recommendations will require certain banks to develop new systems and processes to ensure the accuracy of the information. Many of these systems and processes will overlap with those needed to respond to other recent requirements such as those from Basel III, financial reporting or other regulatory information requests.

Banks that wish to adopt the EDTF recommendations should evaluate the required data processes and controls in the context of these and other requirements.

The EDTF recommendations are yet another example of the increasing trend impacting banks that requires a coordinated response from both risk and finance functions. As with many other current regulatory, rating agency and other stakeholder requests, the alignment of risk, finance and operations infrastructure to support information requirements is needed for efficient and effective development of accurate and efficient responses. Finally, these recommendations represent one more step towards reporting that requires more forward-looking information that departs from financial reporting focused on historical results.

Figure 2. Illustrative prioritization of quantitative risk disclosure recommendations

Institutions that plan to align to the EDTF recommendations can prioritize quantitative disclosures that can be implemented in the short-term with a relatively low level of effort.



Appendix. Detailed risk disclosure recommendations

The 32 EDTF recommendations focus on enhancing the transparency, granularity and comprehensiveness of risk disclosures across seven key areas.

Risk Area	Recommended Disclosures
General	• Consolidated risk report and definitions of the bank's risk terminology and measures • Timely discussion of top and emerging risks, including recent changes and quantitative disclosures • Discussion of plans to meet each new key regulatory ratio once applicable rules are finalized (e.g. LCR, NSFR, and leverage ratio) and providing such ratios once the rules are effective
Risk Governance / Risk Management	• Description of risk organization, key processes, functions, risk culture, and stress testing process and use of stress testing for risk and capital management • Description of key risks arising from the bank's business model and activities, and relevant risk management processes, and an articulation of risk appetite in the context of the business model
Capital Adequacy and RWA	• Disclosures of minimum pillar 1 capital requirements and capital surcharges for SIFIs and the application of counter-cyclical capital buffers • Summarized information from the capital composition templates as adopted by the Basel Committee to provide an overview of the significant components of capital • Flow statement of movements in regulatory capital including changes in Tier 1, Common Equity Tier 1 and Tier 2 capital for the period • Qualitative and quantitative discussion of capital planning and strategic planning • Tabular information on RWAs that map sources of risk to regulatory capital required for credit and market risk in a clear and consistent manner • Tabular information for capital requirements based on standardized and IRB method for risk-weighted assets calculations for credit, market and operational risk • Tabular presentation of average PD, LGD and EAD, total RWA and RWA density for Basel asset classes and major portfolios within Basel asset classes • RWA flow statement that reconciles movements in RWA for the period for each RWA risk type • A narrative putting Basel Pillar 3 back-testing requirements into context, including model performance and validation against default and loss
Liquidity and Funding	• Description of process to manage potential liquidity needs, and quantitative analysis of the components of the liquidity reserve held to meet these needs • Tabular summary of encumbered and unencumbered assets by balance sheet categories, including collateral received that can be rehypothecated or otherwise redeployed • Tabular analysis of consolidated total assets, liabilities and off-balance sheet commitments by residual contractual maturity. Discussion of approach to determine behavioral characteristics • Discussion on the bank's funding plan including key sources and any funding concentrations, including changes in those sources over time.
Market Risk	• Qualitative and quantitative decomposition of significant market risk factors beyond interest rates, foreign exchange, commodity and equity factors for trading and non-trading market risk measures • Quantitative or qualitative disclosures of model limitations, assumptions, validation procedures, changes and trends in risk measures, and VaR back-testing, etc. • Describe primary risk management techniques used for stress testing, measuring tail-risk and managing illiquid positions
Credit Risk	• Significant credit risk concentrations and quantitative summary of aggregate credit-risk exposures that reconciles to the balance sheet and incorporates off-balance sheet commitments by type • Description of the policies for identifying impaired or non-performing loans and a flow statement of balances of non-performing loans and allowance for loan losses in the period • Quantitative and qualitative analysis of the counterparty credit risk, with a breakdown of exchange-traded vs. OTC derivatives, and a description of collateralization agreements • Provide qualitative information on credit risk mitigation, including collateral held for all sources of credit risk and quantitative information where meaningful
Other Risks	• A description of "other risk" types based on management's classifications and a discussion on how each risk is identified, governed, measured and managed • When material risk events have occurred, discuss the effect on the business, the lessons learned and the resulting changes to risk management processes

Additional information

Primary contacts:

Robert Sullivan	646 471 8488	robert.p.sullivan@us.pwc.com
Simon Gealy	678 419 1699	simon.d.gealy@us.pwc.om
Alejandro Johnston	646 471 7517	alejandro.johnston@us.pwc.com

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
Financial Services Regulatory Practice Marketing Leader
646 471 0588
alison.gilmore@us.pwc.com

www.pwcregulatory.com

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