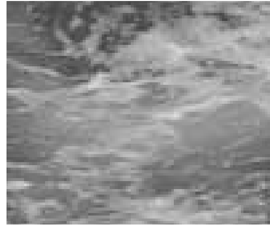

Central bank risk management and international standards

by

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Central bank risk management and international accounting standards

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In June 2002, the European Commission confirmed its decision to require all companies with their shares listed on a recognised European stock exchange to present their financial statements from 2005 in accordance with international accounting standards (IAS), issued by the International Accounting Standards Board (IASB). The increasing importance of the single European market in economic and political terms also highlighted the need for a common reporting "language". A global set of standards has been the goal of the IASB (and its predecessor the IASC) since it was formed in 1975, as set out in the IASB Framework in the concepts that underlie the preparation and presentation of financial statements for external users. A direct consequence is that IAS provides an alternative to the US standards, (US GAAP), the only other globally recognised accounting framework, which is mandatory for all corporations listed in the US markets.

If it is finally endorsed in full for implementation in Europe from 2005, IAS will represent a hugely significant step for Europe and indeed for all countries and institutions operating as part of the international financial community. It also hastens the move towards endorsement of IAS by national standard setters and regulators for use in domestic financial accounting and reporting. In all respects, IAS is designed to provide a level playing field for the raising of cheaper corporate financing in the international capital markets, and to provide financial markets, shareholders, other investors and rating agencies with more comparable information about companies all over the world in a single and common financial reporting language.

The implementation of IAS has many consequences for banks and multinational corporations. It is not simply a question of restating existing numbers in a different way within the finance department and presenting

them in an IAS format. Complex new rules associated particularly with financial instruments represent a massive shift in conventional treasury, product, financial and operational risk management techniques. These are discussed in more detail in the paragraphs below.

This is of considerable significance for central banks on several levels. As the main financial regulators in many countries, central banks will have to deal with the impact on regulatory capital and with any fallout in the financial markets as a result of the increased volatility in reported earnings. Many banks and other financial institutions, and to a lesser extent corporate treasuries, that will be the most affected by the introduction of the new standards continue to express grave doubts about certain aspects of them, in particular, in IAS 32 and 39, in respect of hedging, asset classification, derecognition and fair value rules relating to financial instruments. As more banks and corporations move towards IAS in 2005, central banks will be at the forefront of assessing and managing the implications for regulatory capital management and assessing implications for financial stability in the financial sector as a whole.

At a deeper level, central banks which adopt IAS will need to be fully aware of the consequences for their own accounting, financial reporting and risk management. But what direct relevance do these IAS have for central banks? Aside from the financial sector impact already noted, central banks operate in many instances as fiscal agent of the government, maintaining stability of the domestic financial sector, defending the currency and managing the country's foreign exchange reserves. They also collect financial statistics from the markets for monetary policy purposes. Their objectives, activities, stakeholders, and risk management and external reporting requirements are very different from those of listed, profit-oriented entities.

This chapter considers whether central banks will adopt IAS and explores the effects that central banks' observance of IAS would have on their risk-management practices. It first considers these effects in broad terms, and then discusses the impact in particular of the fair valuing of foreign exchange reserves and other assets, and the treatment of derivatives and the related hedging strategy.

Background to IAS

The European Union has endorsed all of the IAS standards for implementation in Europe, except IAS 32 and 39, which remain to be finalised by March 2004. However, they have been the subject of intense

debate, particularly within the banking industry and the European Banking Federation, and amongst the insurance community. These two standards were reissued as "provisional final standards" in December 2003 after being amended to take account of concerns expressed by regulators and market participants. One of the major concerns, which is directly linked to risk management, was associated with the new rules on hedge accounting, which themselves are in a separate IAS 39 exposure draft on macro-hedging of interest-rate risk in a portfolio of assets, which was issued as a result of industry concerns.

Several of the most challenging elements, which will affect all operational activities of financial institutions, including central banks, are highlighted below. Rules in IAS 32 relating to the definition of capital – the principle of economic compulsion attached to, for example, a preference share coupon – may result in some existing capital instruments being classified as liabilities and not equity. In IAS 39, most assets and liabilities will have to be carried at fair value, and not at historical cost as so many central banks do, as with, for example, their inventories of gold and investments. In addition, the complex new requirements require all derivatives to be fair valued and carried on the balance sheet. Although both changes in fair value of hedged items and related hedging instruments must be shown in the income statement, overall, these requirements are expected to lead to significant earnings and capital volatility. The difficulty is exacerbated by complex rules for hedging activities, including a requirement for the continuous measurement of the effectiveness of each individual hedge. Failure to meet these criteria, which require a hedging relationship to "almost fully offset", ie, to be 100% effective, results in ineffectiveness, de-designation of the hedge and the resulting gain or loss taken to the income statement.

There are strict new rules also on impairment and provisioning generally, which prohibit the creation of general banking reserves to cover unforeseen circumstances. This contradicts the fundamental conservatism and prudence of central banks, and therefore directly affects the way they manage risk in their own activities These rules will have a direct impact not only on the accounting but also on the traditional risk-management practices of all institutions, banks, corporate treasuries and investment firms.

Balance-sheet management and risk assessment will be affected. Derivative financial instruments, including interest rate and currency swaps, option contracts and other derivatives are required to be measured at fair value on the balance sheet. There are separate rules for embedded derivatives.

What risks do central banks need to manage?

Central banks typically expose themselves to a variety of risks, including market, credit, interest rate and liquidity risk (although the last of these can be mitigated – with unwelcome consequences – by the issue of currency). Aside from credit risk involved in lender of last resort operations, these risks will generally be mostly linked to exposures on foreign assets and liabilities. In addition, a central bank is exposed to significant reputational and operational risk as well as legal risk. Christian Noyer[1] points out that financial risk can be increased, for example, by virtue of policy decisions on foreign currency exposure, in particular reserve assets, for currency management reasons. This, together with exposures to domestic and foreign interest rates, is the main source of financial risk and, given its policy nature, is not normally hedged. Further increased sophistication of markets and institutions, and dependency on technology by banks and the central bank itself, create additional risk.

Level of risk awareness in central banks

On a general level, the Central Banking Publications survey in 1999 found that risk awareness in central banks is at a fairly low level; only 15% of central banks surveyed have an independent risk-management unit[2]. Formal responsibility for monitoring and management of risk is still generally decentralised at departmental or head of function level. This results in a focus on the control of risk rather than active management of it. Many would argue that it is not for a central bank to actively manage risk for its own benefit, since this may conflict with its statutory objectives associated with ensuring stability of the financial system and defending the currency. It is particularly in the context of foreign exchange and foreign exchange reserves management that this issue is relevant for a central bank.

Global developments since 2000 will have contributed towards a far greater awareness of the need for the identification, measurement and management of risk at all levels of the organisation. However, PricewaterhouseCoopers's recent experience indicates that risk-management practices, including the existence of a central risk management function, are only now being developed in many central banks. The monitoring and/or management of

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1 See page 9 in Frowen, S.F., Pringle, Robert and Benedict Weller (eds) (1999) *Risk Management for Central Bankers*. London: Central Banking Publications.

2 See page 3 in Frowen, S.F., Pringle, Robert and Benedict Weller (eds) (1999) *Risk Management for Central Bankers*. London: Central Banking Publications.

risk, including reporting to risk committees on daily risk exposures, limits etc, usually lies in the financial markets area and in the reserve management department. Only a few central banks seem to have a separate risk management function responsible for central bank-wide risk. Several developing countries' central banks are in the process of implementing a separate risk management department that monitors the central bank-wide risks.

Commercial entities consider the monitoring and management of risk as an opportunity to maximise profits, and will undertake risk assessments and set risk limits and risk appetites within which operational departments will be required to perform. The core financial strategies for dealing departments remain geared towards arbitrage and other market opportunities to maximise shareholder value through increased profits. Central banks need to combine liquidity, safety and the enhancement of returns on invested funds, which represent the fundamental criteria in designing the framework for managing its reserves, including modelling of financial risks. All financial institutions will therefore seek to actively manage risk, but a more conservative approach adopted by central banks exposes it to lower levels of risk.

Why have central banks not adopted IAS?

Central banks have typically employed national accounting and financial reporting standards, in many cases tailored to accommodate central bank-specific activities. This has reflected the needs of government or finance ministry reporting within the context of the state sector. No central bank outside the euro area employs the European System of Central Banks's standards, although it is not unreasonable to assume, based on PwC's experience, that most EU accession countries have assessed what changes they will be required to make in order to fully comply. ESCB accounting standards for central banks are the closest to a recognised and commonly adopted accounting framework of central bank-specific standards.

Importantly, these standards are based on IAS but differ in certain key areas, most notably regarding recognition of gains and losses from foreign exchange revaluations. These are the key differences which are causing concern among central banks that are moving their accounting towards IAS. Under Eurosystem rules, all unrealised gains are excluded from income while IAS 21 requires all realised and unrealised gains and losses to be recognised in income. Under Eurosystem rules currency movements can, therefore, be managed in the knowledge that no unrealised gains will be distributed as dividend. A positive net unrealised foreign exchange revaluation gain would be carried in the balance sheet, creating much-needed reserves in the

valuation of the foreign exchange portfolio. Since central banks often have a very large structural foreign exchange exposure, they need large reserves as a buffer against adverse foreign exchange movements. The provisioning methodology under IAS does not permit such "general" buffers or banking reserves.

The recent Central Banking Publications survey[3] revealed that only 39% of respondents had adopted IAS to some degree and only 27% had adopted them in full. For most central banks that have considered the application of IAS to their accounting and reporting, the key differences and difficulties they encountered were in four broad areas: (i) treatment of unrealised revaluation differences (IAS 21) (with particular emphasis on income recognition and dividend policy); (ii) fair value accounting instead of historical cost; (iii) financial statement presentation, including cash flow and consolidation of subsidiary entities; and (iv) other adjustments including revaluation of fixed assets, inflation accounting, etc. Each of these areas has a direct impact on operational activity and risk management across the institution.

Interestingly, in common with many other financial institutions, central banks have not considered more widely the operational impact of IAS within the business, particularly with regard to the extra data, systems and technical knowledge required to accommodate new IAS approaches to hedging activities, measurement of fair value and use and disclosure of derivatives. Experience to date of those companies currently preparing for the change shows that this is much more than simply a question of the finance function collecting, collating and presenting financial information in a different format. The impact will be significant and will affect every aspect of the activities of the front and back offices, internal financial and operational data management, IT and management information systems, corporate governance and risk management, as well as staff training and development. Central banks will be affected once they adopt IAS.

Common accounting standards for all central banks?

To date, central banks have operated broadly under the assumption that individual IAS are applied to the extent that they are considered applicable or relevant to the business and operations of a central bank. However, IAS requires full compliance with all standards, with very few circumstances in which non-compliance is permitted.

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3 See Courtis, Neil and Mander, Benedict (eds) (2003) *Accounting Standards for Central Banks*. London: Central Banking Publications.

The time is ripe for a wider initiative for the development of a set of central bank-specific accounting standards, recognising that non-standard accounting in certain areas represents prudent central bank activity and should not be equated with the "earnings management" techniques that have tarnished the reputation of the corporate sector. A comprehensive and transparent set of rules can be applied to all institutions in order to provide a more consistent picture of activities and financial position. Ideally, individual country legal and reporting practices would be amended so as to be compliant with this global set of central bank standards.

Likely impact of IAS on central bank risk-management practices

It is clear from the above that central banks do not consider the main effect of adopting IAS as affecting risk-management practices. However, central banks will be affected in a number of key areas, with at least three effects on operational decision-making and risk strategies. First, if the central bank adopts a portfolio approach to the management of the foreign exchange position, including internal hedging through a central treasury function, IAS requires the hedged asset and related hedging instrument to be clearly documented, and individually designated rather than hedged on a net basis. Strict hedge effectiveness measurement criteria provide a major challenge to data systems and traditional hedging strategies.

Second, many central banks hold government debt instruments in their balance sheet, which IAS requires should be recorded at fair value, using discounted cash-flow techniques in the absence of a market price. It is often extremely difficult, not to say potentially damaging to sovereign ratings, to determine a fair value for government securities, especially with zero coupon, long or un-dated paper. "Fair value" may be significantly less than historical cost, resulting in substantial losses and potential technical insolvency of the central bank. In addition, the unwinding of the discounted value in future years results in unrealised gains in the income statement, whose distribution in the form of dividend to government or treasury is an inflationary emission.

Third, gold is considered as bullion under IAS, a non-financial asset, and is therefore recognised at the lower of cost and net realisable value in accordance with IAS 2. Many central banks carry gold at historical cost, which is significantly below market or fair value. If central banks were to recognise unrealised revaluation gains on this gold as income, this may lead to their distribution as dividends, with consequences for inflation and money supply.

Importantly, the IASB did attempt to understand the realities of foreign currency risk management within a multinational organisation, including a central bank. It is hoped that further amendments to IAS 39 will permit the use of internal derivatives in foreign currency hedge accounting, provided that the net exposure is laid off externally in such a way that the net mark-to-market gain or loss on the external derivative fully offsets the net gain or loss arising on the internal derivatives.

Externally, the UK's Financial Services Authority (FSA), as banking supervisor is closely monitoring developments, assessing the extent to which prudential measures and regulatory guidelines will need to change to accommodate the capital and operational aspects of implementation. This is a core element of the approach to financial-sector risk management by the central bank as banking supervisor and therefore requires detailed and immediate attention by all regulators in order to assess the potential impact and likely contingency planning. In a letter to all companies with securities on the UK Listing Authority's Official List, the former chairman of the FSA, Howard Davies, expressed concern about the lack of preparedness for IAS amongst institutions, and indicated that any failure by issuers to submit preliminary or interim results within the required timescale is likely to result in the suspension of the issuer's securities. This heralds a clear warning for the markets, and also increases the pressure on regulators' own approach to regulatory risk management.

In addition, the European Central Bank is currently undertaking a study in this area, as is the FSA, but it will be increasingly important during 2004 for regulators to consult market participants, standard setters and other interested parties, so that they can develop any necessary amendments to regulatory and prudential reporting requirements in order to ensure consistent, timely and comprehensible financial reporting in the new IAS environment. And the Committee of European Securities Regulators, of which FSA and other leading regulators are members, set out a draft recommendation in late 2003 for listed companies to consider in publishing IAS information. There are differing views as to how companies should report their first IAS information, and regulators and supervisors may need to coordinate their activities across Europe in order to manage the risks to the financial markets.

Central bank risk management and IAS

Central banks are increasingly recognising that their accounting and financial reporting needs to reflect trends in the markets, which they regulate. One direct consequence of this is that central banks need quickly to understand

what the new rules are and how they will impact on the operations and management of risk in banks and in their own activities.

Therefore, in a wider context, it is important to understand firstly that the new rules are likely to result in significant income and capital volatility for institutions. In particular, there will be more focus on "hidden reserves" in central bank balance sheets, those unrealised gains which have built up over many years and which represent the reserve capital that central banks need to build up and manage rather than distribute to treasuries to cover government finances. The adoption of IAS as a whole is designed to result in greater transparency for central banks and consequently a better understanding of the complex nature of their activities. However, political pressures may increase in the event that there are conflicting needs of state budget and central bank independence and prudence.

Secondly, in the markets that the central bank regulates, there will be some potentially unexpected swings in reported results and levels of capital, which the regulator will have to anticipate and deal with. In countries where the central bank is the listing authority on the stock exchange, capital and earnings volatility will add to the existing nervousness of investors and other stakeholders in financial and corporate markets. The IASB is being strongly encouraged to ensure that the proposed approaches to hedging under IAS do not result in excessive additional cost and operational inefficiencies as the result of the need to amend the existing risk-management strategies and business models that have been developed and applied by management on a similar basis in many institutions. Risk strategies are based on economic not accounting hedges.

Thirdly, in addition to the potential market volatility, a factor which is often not given the importance it deserves when considering IAS, is the ability of central banks to continue to collect meaningful statistical data from the markets as part of its monetary policy role. Operational data, including savings, borrowing etc forms an important indicator in setting interest rates. The Bank of England is already taking steps to address this, consulting closely with the UK Treasury on assessing the impact on government policy and decision-making. This raises an additional reputational risk for central bankers.

The process will be a significant challenge for all central banks, but the gains should be commensurable.