FSB FINANCIAL STABILITY BOARD

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Summary of key themes that arose during an FSB roundtable on risk disclosure

The FSB held a roundtable on risk disclosure in Basel on 9 December 2011. Eighty-two senior officials and other experts from around the world took part in the roundtable, representing investors and analysts, asset managers, credit rating agencies, banks, insurance companies, audit firms, audit regulators, accounting and auditing standard setters, as well as prudential and market authorities. It fostered a rich and lively dialogue about the current state of risks and related disclosures and how to improve their transparency.

The key themes that arose during the course of the discussion are summarised below:

Risk disclosure foundations

Participants generally preferred risk disclosure requirements in accounting standards and securities regulatory requirements that are principles-based rather than rules-based, but investors also called for measures to improve comparability, such as more consistent risk disclosure formats or templates. Principles-based approaches, such as those in the IASB's IFRS 7 (on financial instrument disclosure) and the US Securities and Exchange Commission's guidance on management's discussion and analysis (MD&A), may be sufficient to underpin disclosure improvements of the type discussed at the roundtable without the issuance of new disclosure requirements, but greater attention needs to be paid to address user needs for information about emerging risks. A key theme raised was that while participation from the private sector is essential in driving forward leading practice risk disclosures, the public sector also plays a vital role in promoting financial stability and in encouraging improved disclosure practices.

Views of regulators and accounting standard setters. The IASB and FASB discussed their initiatives in recent years to enhance risk disclosures. These include IASB improvements in standards for disclosures about financial instrument risks and valuations, and about off-balance sheet exposures, and FASB enhancements in standards for disclosures about credit risk, valuations and off-balance sheet risks. The two Boards have issued converged standards for disclosures about the gross and net exposures associated with derivatives and certain other financial instruments.

Regulators generally acknowledged some recent improvements in risk disclosure practices but they shared the view that further improvement would be useful to enhance transparency. Securities regulators noted the benefits of regulators and firms reaching out to key stakeholders about disclosure issues and the importance of monitoring information discussed during senior management calls with analysts and the related presentations, which could provide insights into ways to improve financial report disclosures. They noted, however, that this required significant resources. The Financial Policy Committee of the Bank of England has encouraged improvements in the quality of disclosures as indicated the Bank's Financial Stability Reports in June and December 2011. Participants noted that banks and investors in emerging market economies may not have the capacity to produce and assess more granular disclosures of the types that some were recommending during the roundtable.

The role of auditors in risk disclosures. External auditors are currently required to consider the risk of material misstatement of the financial statements in planning and performing the audit. Where the applicable accounting framework requires disclosure in the financial statements of information relating to risk, the auditor is required to audit that disclosure. The auditor's responsibility for disclosures in documents accompanying the financial statements – such as those in MD&A or the financial review section of financial reports – is generally limited to considering whether it is materially inconsistent with the audited financial statements or a material misstatement of fact. Auditors' roles are also limited with respect to disclosures in interim financial reports. Generally, other risk disclosures, such as those in presentations to investors and analysts or on a firm's websites, are not subject to external auditor's review.

Audit regulators and standard setters summarised their recent guidance which included (i) alerts to auditors for assessing and responding to the risk of material financial statement misstatement in this difficult economic environment and (ii) consultative documents to explore possible improvements in auditor reporting and/or changes in the role of the external auditor for disclosures outside the financial statements (e.g., risk disclosures in MD&A). They are considering ways of expanding the scope of risk-related reporting responsibilities through consultative documents issued in 2011 and further work planned for 2012. Challenges remain in areas such as auditability of forward-looking statements, application of materiality concepts, and going concern assessments.

Improvements needed in financial institution risk disclosures

Investors and analysts stressed that disclosure that enhances the transparency of risks and risk management practices helps to build confidence in the firm's management, which can be particularly important to attract debt and equity investors. However, they argued that still many financial firms provide only minimal risk disclosures or obscure important information in voluminous disclosures that are not relevant or prioritised. Many participants encouraged that disclosure on past risks no longer of key importance should be allowed to be phased out, to ensure more relevant disclosure and avoid unnecessary reporting burden.

Given the current financial market environment, participants expressed the view that enhanced qualitative and quantitative disclosure is particularly important in the following areas:

Information on governance and risk management strategies. Investors requested better qualitative disclosures about governance, risk management oversight and related controls, and qualitative and quantitative disclosures about risk management practices, risk exposures and remuneration. Banking and insurance representatives noted the relevance of information about a financial institution's risk appetite and that risk disclosures would be most relevant if they were consistent with information used internally for risk management purposes. Disclosure should be put in the context of the financial institution's business model to facilitate market understanding of risk management practices.

Summary disclosure and benefits of achieving comparability. Participants agreed that risk disclosure should be timely, clear, prioritised, consistent and comparable, as highlighted by a recent survey of financial report users. Many analysts recommended more use of executive summaries of the key risk categories, which should include key metrics on entity-wide risk exposure and risk management effectiveness. Disclosures should better differentiate market risk components (e.g., interest rate, foreign currency and commodity risk as separate disclosure categories) and firms should avoid voluminous or boilerplate disclosures presented as a compliance exercise. Some supported the idea of standardised common disclosure templates to facilitate comparability across firms and jurisdictions and to aid aggregation and assessment of system-wide risks. Others pointed out that risk disclosure should be supported by qualitative information that provides management's context for measurements and important firm-specific considerations.

Credit risk. While acknowledging that some banks have enhanced their disclosures in recent interim reports, participants encouraged improved disclosure about exposures to sovereign debt and to other financial institutions. In addition to the areas for potential enhanced credit risk disclosure raised in the FSB Report, including the disclosure of renegotiated loans for troubled borrowers, participants discussed other areas where enhanced risk disclosure could be useful, such as: (i) expected credit losses for impaired financial assets, (ii) counterparty exposures, (iii) derivatives, (iv) off-balance sheet and joint venture structures, and (v) risk concentrations.

Liquidity risk. Participants noted the importance of transparency about liquidity and funding risks, including potentially additional disclosures about sensitivity analyses, sources and volume of liquidity buffers, and maturity tables including contingent lending commitments. Given the increasing role of collateral, participants shared the view that the degree of asset encumbrance should be disclosed at a reasonable interim frequency as well as annually. Some mentioned the importance of addressing the liquidity of collateral and the extent of its use and residual availability.

Capital adequacy and risk weighted assets (RWAs). Participants said that disclosures on capital planning (including the ability of firms to transfer capital across borders) were important. An issue of concern was the resilience of earnings since, for example, extended periods of low interest rates could erode banks' profit margins and impose downward pressures on bank capital ratios. Further disclosure about RWAs and their calculation methods would be helpful. Investors noted as a positive development that some banks had started to disclose their regulatory leverage ratios voluntarily.

Pillar 3 disclosure. Participants indicated that the usefulness of Pillar 3 disclosures was hampered by difficulties in reconciling the unaudited Pillar 3 information to the audited financial statements of firms. Participants generally supported more integrated presentation which would, for example, better link and allow navigation between the Pillar 3 and financial report (e.g., IFRS 7) risk disclosures, align the timing of their publication, and achieve more comparability across jurisdictions and banks. For example, there are several methods available under Pillar 3 for disclosures about certain risks and collateral. In addition, some noted as important that liquidity information was included in the Pillar 3 framework, as set forth in the Basel Committee's current plans.

Scenario and sensitivity analyses. Some participants expressed their desire that the results of stress tests should be disclosed in financial reports, possibly with an indication as to whether the results are reviewed by external auditors. Care should be taken to properly interpret stress test results and summarise information in a manner useful to investors (e.g., using the impacts on earnings and capital of a certain change in interest rates, providing relevant information about non-linearity).

Conclusions

The roundtable showed the value of robust exchanges on shortcomings in disclosures among a wide range of private sector and public sector stakeholders. The full range of participants – users and providers of disclosures, auditors, regulators and standard setters – agreed that it would be important for investors, financial institutions and auditors to develop principles and formats for better risk disclosures going forward, with input from standard setters and regulators, as recommended in the FSB Report. Participants noted that these principles and leading practice disclosures should be broad in scope to avoid disclosure arbitrage among various market participants.

However, some felt that the private sector would not initially be able to carry forward this work on its own. Some called for more proactive involvement of the official sector under the current stressed situations where voluntary risk disclosure initiated by some in the private sector alone might not be sufficient to restore confidence quickly. Many expressed the view that the FSB should continue to help encourage and facilitate this work, perhaps by conducting another roundtable in 2012 and prompting a task force of investors, analysts, rating agencies, financial institutions, and auditors, with input from standard setters and regulators, to take forward this work.

The FSB Plenary has considered the views expressed during the roundtable and by its members and has decided next steps to enhance risk disclosure practices, as described in its press release in March 2012.