

## ENHANCED RISK DISCLOSURE BY BANKS

### An Investor Perspective

FEBRUARY 2013



The Enhanced Disclosure Task Force (EDTF), created by the Financial Stability Board (FSB) in May 2012, published on 29 October 2012 a report presenting a series of recommendations on how banks can enhance risk disclosure.<sup>1</sup>

BlackRock was an active participant in the EDTF and helped co-author this report.

Rebuilding trust between banks and investors in the aftermath of the financial crisis is key to re-launching sustainable economic growth. In this ViewPoint, we underline the importance of enhanced disclosure in restoring trust in the banking system. We outline the key principles for enhanced risk disclosure set out in the EDTF report as well as its

#### BACKGROUND ON THE EDTF

The EDTF was established in May 2012 by the FSB to develop fundamental principles for enhancing risk disclosure practices by major banks. Its membership reflected a wide range of preparers and users of financial reports globally and comprised banks, asset managers, auditors and credit rating agencies. It was also mandated to recommend improvements to current risk disclosures, including ways to enhance their comparability and to identify examples of best or leading practice risk disclosures presented by global financial institutions. As requested by the FSB, the EDTF also maintained extensive outreach with regulatory and standard-setting bodies as it prepared its report.

Members of the EDTF task force are: Eurex Group, HSBC, PIMCO, Allianz SE, Barclays Capital, BlackRock, BNP Paribas, CFA Institute, Commonwealth Bank of Australia, DBS, Deloitte, Deutsche Bank, Ernst & Young, Fidelity Management and Research, Fitch Ratings, ING Group, Institutional Investment Advisors Limited, International Banking Federation, International Corporate Governance Network, JPMorgan Chase, KPMG, M&G Investment Management, Mitsubishi UFJ Financial Group, PGGM, Pricewaterhouse Coopers, Royal Bank of Canada, Santander, Société Générale Corporate and Investment Banking, Standard & Poor's, UBS and the Institute of International Finance.

examples of best practices. If properly implemented by the banking sector, these principles will be highly beneficial for investors and other stakeholders as well as for the banking system itself.

The EDTF is unique in that it reflects the work of a group of private sector institutions, both preparers and users of financial reports. We hope stakeholders closely review the findings of the report and support the EDTF's aims of restoring trust in financial services.

#### Restoring trust in the banking system through a better understanding of banks' risk

Since the start of the financial crisis, banks have suffered from a higher cost of funding and reduced access to capital markets, in part due to a lack of investor confidence in their business models and risk control systems. Credit spreads for many banks remain higher than those of corporates with the same credit rating. While some banks are actively lending, the knock on effect has been that many, and particularly those in Europe, remain constrained in their ability to serve their normal function in the economy, which is the intermediation of credit to support employment and productive investments.

BlackRock believes that banks can better serve the broader economy if investors gain a better understanding of banks' risks and of the complexity of their business models. This will help restore trust in the financial system and make the cost of capital for banks more reflective of their real risks. The need for investors to understand banks' risks and how they manage them will become all the more important as implicit government support for banks is replaced by "bail-in" arrangements, where losses following a bank default will be borne by the bank's investors.

The EDTF report concluded that a major step towards restoring trust will be enhanced disclosure of risks undertaken by banks, including:

- ▶ Key risks arising from banks' business models and how these risks are measured
- ▶ Key risks arising from banks' liquidity positions, sources of funding and the extent to which banks' assets are not available for potential funding needs

<sup>1</sup> A copy of the full report is available at: [https://www.financialstabilityboard.org/publications/r\\_121029.pdf](https://www.financialstabilityboard.org/publications/r_121029.pdf)

- ▶ Banks' credit counterparty risks and how banks' risk-weighted assets (RWAs) are calculated, what the drivers of changes in RWAs are and how banks' regulatory capital are measured
- ▶ A bank's liquidity position, particularly at the entity level; its sources of funding and the extent to which its assets are not available for potential funding needs
- ▶ How the measure of a bank's market risk is related to its balance sheet
- ▶ The nature and extent of a bank's loan forbearance and modification practices, and how they may affect the reported level of impaired or non-performing loans

## Principles of risk disclosure to deliver improved transparency

The ten banks participating in the EDTF have committed to abide by the following principles. Disclosures should:

1. Be clear for a range of users, balanced between qualitative and quantitative disclosures and understandable with straightforward explanations for more complex issues
2. Be comprehensive and include all the bank's key activities and risks
3. Present relevant and sufficiently detailed information eliminating immaterial information and generic disclosures not adding any value for investors and making sure its business model is well explained
4. Reflect how the bank manages its risks based on internal strategic decision making and risk management and include an explanation of the risk and reward profile of the bank's activities. Level of information given to investors will need to balance confidentiality and materiality
5. Be consistent over time to help the investors understand the evolution of the bank's business model and risk profile
6. Be sufficiently detailed to make them comparable among competing banks
7. Be provided on a timely basis and regular updates of financial information should be given to the investors

BlackRock recommends that other banks that regularly access capital markets follow suit. Implementing these principles will facilitate funding at terms that more accurately reflect their risks.

## Recommendations for enhancing risk disclosures

The EDTF identified a series of recommendations for enhancing risk disclosures, covering risk governance and risk management strategies, capital adequacy and risk-weighted issues, liquidity, funding, market risk, credit risk and other forms of risk. End-investors would benefit from clearer, timely,

more useful and improved comparability of information on banks' risk and a better understanding of how banks manage their risks.

On risk governance and risk management strategies, the report recommends that banks fully report on their risk management functions and culture, and fully describe the key risks that arise from their business models and how they manage them. It also urges banks to describe how they use stress testing within their governance and capital frameworks.

On capital adequacy and risk-weighted assets, the EDTF report recommends that banks present a table showing the capital requirements for each method used for calculating risk, including counterparty risk, for each Basel III asset class as well as for major portfolios for those classes. It also encourages them to provide a narrative putting Basel III Pillar 3 back-testing requirements into context, including how they assessed model performance and validated its models against default and losses.

The report also recommends that banks describe the way they manage their potential liquidity needs and provide a quantitative analysis of the components of the liquidity reserve held to meet these needs, ideally by providing averages as well as period-end balances. This description should be complemented by an explanation of possible limitations on the use of the liquidity reserve maintained in any material subsidiary or currency.

## Conclusion

A strong financial services industry is essential to the wellbeing of the wider economy and society in general. Banks clearly have a vital role to play, but in order for them to fulfill their responsibility they need appropriate access to capital markets. The ability of banks to access funding has been undermined in part by the erosion of trust between banks and their investors. Rebuilding this trust will be necessary in order for the global economy to recover – but it will not be a simple process.

BlackRock endorses the EDTF report's argument that better risk disclosures are an important step in re-establishing trust between banks and investors. We also support the seven fundamental principles for enhancing the risk disclosures of banks outlined in the report, which we believe will provide a firm foundation for developing high-quality, transparent disclosures that clearly communicate banks' business models and the key risks that arise from them.

We believe that the adoption of the recommendations in this report can make a significant and enduring contribution to restoring investors' confidence and trust in the banking system. The ultimate success of the report will be judged on the willingness of large international banks to enhance their risk disclosures proactively by implementing our recommendations.

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