FACILITATING INVESTOR ROLE IN MARKET DISCIPLINE: CRITICALITY OF TRANSPARENT REPORTING

Vincent Papa
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KEY POINTS

• Bank Transparency Matters
• Areas where investors required improved reporting
• Thoughts on Necessary Way Forward
TRANSPARENCY MATTERS FOR INVESTORS

LCFIs are complex, have inherently opaque loans assets but enhanced transparency significantly matters because it

- *Impacts on investor confidence*

- *Enables raising of risk capital*

- *Impacts on market discipline abilities of investors*
COMPARING INVESTMENT GRADE FINANCIAL AND NON FINANCIAL COMPANIES
Risk Aversion Towards Banks Evident in Incremental CDS Spread
PRICE TO BOOK (P/B) RATIO DECLINES
FACTORS INFLUENCING LOW P/B

**ASSET QUALITY**
- Asset Impairments [Loans, Securities, Goodwill]

**RISK/COST OF EQUITY**
- Funding and Liquidity Risk
- Financial Instruments
- Exposure
- Capital Adequacy and Leverage
- Information Risk
  - Balance Sheet Misstatements
  - Low Earnings Quality
  - Poor Risk Disclosures

**FUTURE PROFITABILITY EXPECTATIONS**
- Reported ROE
- Economic Outlook
- Regulatory Reform Impact
- Value Chain and Business Model Shifts
- Interest Rate Environment

VALUATION METRIC

Price
Book
BROAD SHORTCOMINGS OF CORPORATE REPORTING

- Do financial statements show economics of business
  - Misstated balance sheets, misstatements (overstated assets, understated liabilities)
  - Do reported numbers reflect economic reality?
  - Unreported exposures

- Complexity compounded by poor communication
  - "I am a trained accountant and can barely grasp the intricacies and technicalities of the risk reports in bank financial statements" - Seasoned generalist investor
  - How is business model translating to reporting outcomes?
  - Poorly organized, fragmentary, insufficient top-down messaging

- Poor risk reporting
  - EDTF focus areas (capital adequacy, liquidity and funding, market risk, credit risk and derivatives)
SPECIFIC AREAS WHERE INVESTORS REQUIRED IMPROVED REPORTING

Loan Impairments
(Loans > 50% assets in most bank balance sheets)
- Forbearance inconsistencies across banks and impact on non-performing loans
- Too little, too late write-downs due to incurred loss impairment methodology

Securitization and off-balance sheet exposures
- Identifying continuing involvement with structured entities
  Transparency on retained interest exposure

Derivatives Exposures
- Measurement reliability of illiquid instruments
- CVA, DVA, FVA measurement inconsistencies
- Incomparable offsetting across US GAAP and IFRS (Top 5 US banks- 4.82% under IFRS, 7.56% under US GAAP; Top 5 IFRS banks- 4.49%)
SPECIFIC AREAS WHERE INVESTORS REQUIRED IMPROVED REPORTING

Risk Reporting
- Risk weighted assets
- Regulatory capital adjustments
- Interest rate risk sensitivity analysis in light of low interest rates

Other areas
- Legal reserves (RBS- 7% of total equity)
- Deferred tax assets
- Goodwill impairment
EFFECTIVE REPORTING YARDSTICK
How well is overall reporting package helping investors understand a bank’s execution of business model, underlying risk exposures and risk management?

- Bank business model choices, regulatory and macro-economic factors
- Return profile & risk exposures
- Balance sheet, comprehensive income statement, disclosures
THOUGHTS ON NECESSARY WAY FORWARD

- **Continued enhancement of risk reporting**
  - Implement EDTF recommendations
  - Effective adherence to IFRS 7, IFRS 9 requirements

- **Ongoing and strengthened regulatory enforcement and co-ordination**
  - IFRS 9 (BCBS guidance)- Emphasis on integrating credit risk management and reporting outcomes
  - Auditability of reporting outcomes IAASB (Financial Institutions ISAs)- how well are auditors able to audit judgment intensive measurements under uncertainty
  - Harmonization of prudential regulator supervisory efforts
  - Strengthening security regulator enforcement actions

- **Improved communication by banks on systemic and emerging risk areas**
  - Derivatives exposures
  - Next problematic asset class (student loans, securitized peer to peer lending, who knows?!)
### Illustrative Significant Derivatives Exposures-2013 Annual Reports

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<th>Bank</th>
<th>Gross derivatives</th>
<th>Derivatives on BS</th>
<th>US GAAP Equivalent</th>
<th>Notional amts</th>
<th>Total assets</th>
<th>Notional amount/Total Assets</th>
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