

# **Enhancing Bank Transparency**

**Public disclosure and supervisory information  
that promote safety and soundness in banking systems**

**Basle Committee on Banking Supervision**

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of the Basle Committee on Banking Supervision**

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## **ENHANCING BANK TRANSPARENCY**

### *Public disclosure and supervisory information that promote safety and soundness in banking systems*

#### **EXECUTIVE SUMMARY**

This report discusses the role of information in effective market discipline and effective banking supervision. It provides general guidance to banking supervisors and regulators as they formulate and improve regulatory frameworks for public disclosure and supervisory reporting, and to the banking industry on core disclosures that should be provided to the public.

The issuance of this paper is based on the recognition that markets contain disciplinary mechanisms that can reinforce the efforts of supervisors by rewarding banks that manage risk effectively and penalising those whose risk management is inept or imprudent. Market discipline, however, can only work if market participants have access to timely and reliable information which enables them to assess a bank's activities and the risks inherent in those activities. Improved public disclosure strengthens market participants' ability to encourage safe and sound banking practices.

The complementary interaction of prudential supervision and market discipline is critical to promoting long-term stability of both individual institutions and banking systems. The effectiveness of the interaction depends greatly on meaningful public disclosure. This document recommends that supervisors focus their efforts on encouraging high-quality public disclosure at reasonable cost. One area in which supervisors are well suited to take on a proactive role, acting alone or jointly with standard-setters, is in enhancing comparability by promoting the use of supervisory definitions and reporting classifications in public disclosure. Supervisors are also encouraged to promote mechanisms designed to ensure compliance with disclosure standards and the strengthening of standards that ensure reliability of information.

The paper recommends that banks, in their financial reports and other disclosures to the public, provide timely information which facilitates market participants' assessment of them. It identifies the following six broad categories of information, each of which should be addressed in clear terms and appropriate detail to help achieve a satisfactory level of bank transparency:

- financial performance;

- financial position (including capital, solvency and liquidity);
- risk management strategies and practices;
- risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks);
- accounting policies; and
- basic business, management and corporate governance information.

The paper also discusses the types of useful information for each category. Finally, the paper encourages supervisors to have access to this and other information of supervisory interest.

## ENHANCING BANK TRANSPARENCY

### *Public disclosure and supervisory information that promote safety and soundness in banking systems*

#### **1. INTRODUCTION**

1. This report, issued by the Basle Committee on Banking Supervision,<sup>1</sup> discusses the role of transparency and disclosure of information in effective market discipline and effective banking supervision. Moreover, it identifies six broad categories of information elements that are needed to provide a basic understanding of a bank's activities and the risks it faces. The paper recommends that banks publicly disclose such information to foster market discipline and strengthen financial stability by promoting transparency of banks' activities and risk exposures. Further, the paper encourages supervisors to have access to this and other information of supervisory interest.

2. The goal of achieving transparency has become more challenging in recent years as banks' activities have become more complex and dynamic. Many banks now have large-scale international operations and significant participation in securities and/or insurance businesses in addition to traditional banking activities. Their product lines change rapidly and include highly sophisticated transactions, and they have complex legal and managerial structures. These banks present formidable challenges to market participants and supervisors who need to formulate ongoing assessments of banks' activities and risks. At the same time as transparency has become more challenging, the potential benefits of disclosure for supervisors have grown as the scope of banks' market activities has expanded, thereby increasing the potential for market discipline to function as a complement to supervision. There have been calls for better transparency by G-7 leaders and finance ministers, regulators and market bodies, especially in the aftermath of financial disturbances and with respect to emerging markets.

3. The publication of this paper is a component of the Basle Committee's long-standing work to promote effective banking supervision and safe and sound banking systems.

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<sup>1</sup> The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

In the Core Principles,<sup>2</sup> the Committee defines minimum requirements that need to be fulfilled in effective banking supervisory systems and discusses arrangements that are needed to promote stability in financial markets. This paper provides an elaboration of certain of the Core Principles, which require banking supervisors to:

- have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis (Principle 18);
- be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable supervisors to obtain a true and fair view of the financial condition of the bank and the profitability of its business (Principle 21, 1<sup>st</sup> clause);
- be satisfied that each bank publishes on a regular basis financial statements that fairly reflect its condition (Principle 21, 2<sup>nd</sup> clause).

4. Banking supervisors' interest in bank transparency is based on the recognition that markets contain disciplinary mechanisms that, under appropriate conditions, reinforce supervisory efforts by rewarding banks that manage risk effectively and penalising those whose risk management is weak or ineffective. Market discipline can only work if market participants have access to timely and reliable information that enables them to assess a bank's activities and the risks inherent in those activities. The role of public disclosure in promoting safety and soundness is discussed in *section 2* of this paper, while *section 3* elaborates on the role of supervisors in improving transparency.

5. Moreover, supervisors need information about banks for their own use. Effective banking supervision requires collection and analysis of information to assess the condition of individual banks and banking systems as a whole. Supervisors must obtain information that enables them to detect potential problems at an early stage and identify trends not only for particular institutions, but also for entire banking systems. Supervisory information needs are discussed in *section 4*.

6. In this paper, transparency is defined as public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices. This definition recognises that disclosure alone does not necessarily result in transparency. To achieve transparency, a bank must provide timely, accurate, relevant and sufficient disclosures of qualitative and quantitative information that enables users to make proper assessment of the institution's activities and risk profile. It is also crucial that the information disclosed is based on sound measurement principles and that the principles are

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<sup>2</sup> The *Core Principles for Effective Banking Supervision* were issued by the Basle Committee in September 1997 after consultation with banking supervisors worldwide.

properly applied. In *section 5*, qualitative characteristics of information that contributes to bank transparency are further elaborated. Specific recommendations for enhancing bank transparency are discussed in *section 6*.

7. The document provides general guidance that should be helpful to banking supervisors, legislators and other standard-setters as they formulate and improve regulatory frameworks for public disclosure and supervisory reporting, and to the banking industry on core disclosures that should be provided to the public. It also provides an overall framework against which supervisors can review public disclosure and supervisory reporting standards and practices in their respective jurisdictions, e.g., when implementing the Core Principles for Effective Banking Supervision.

8. The Basle Committee considers transparency to be a key element of an effectively supervised, safe and sound banking system. It recognises that minimum standards or guidelines for public disclosure do not necessarily assure a sufficient level of transparency in the markets for all institutions. Therefore, banks are encouraged to go beyond the guidelines in this paper to ensure that sufficient and meaningful information is provided to the markets, taking account of market developments and the complexity of their own operations.

## **2. THE ROLE OF PUBLIC DISCLOSURE IN PROMOTING SAFETY AND SOUNDNESS**

9. This section addresses how safety and soundness in the banking system can be strengthened by enhanced transparency through improvements in banks' disclosure to the public. The benefits of public disclosure are discussed, as well as issues that should be considered by supervisors and other public policy makers in designing effective public disclosure standards. It also notes that potential drawbacks of public disclosure, that in certain circumstances can limit the positive impact of transparency, need to be considered.

### **(a) Market discipline and the benefits of disclosure**

10. A sound and well-managed bank should, in theory, benefit when it provides comprehensive, accurate, relevant and timely information on its financial condition and performance, and ability to manage and control risks. Such a bank should be able to access capital markets more efficiently than similar institutions that do not provide adequate disclosures.

11. Market participants benefit from disclosure if they can use the information as a basis for making various types of economic decisions. High-quality public disclosure improves their capability to make informed decisions by:

1. allowing them to more accurately assess a bank's financial strength and performance;
2. increasing the credibility of information disclosed by a bank;

3. demonstrating a bank's ability to monitor and manage its risk exposures, e.g., by the disclosure of quantitative and qualitative information about its risk measurement methodologies; and
4. reducing market uncertainty.

12. There are various ways in which market participants' decisions can contribute to market discipline by providing incentives to banks to conduct their business in an efficient and prudent manner. In essence, market discipline is founded on the observation that a sound and well-managed bank is able to attain better terms and conditions in transactions with informed and rationally-behaving market counterparties. On the other hand, the market will require a higher return from funds invested in, or placed with, a bank that is perceived as having more risk. For example, current holders of traded instruments issued by a bank with increasing risk exposures may offer their holdings for sale, thus creating downward pressure on the price of those instruments, and thereby negatively influencing the price at which the bank may raise new funds in the future.

13. Market participants also provide disciplining incentives by modifying transaction terms other than price. For instance, they may reduce the volume or narrow the range of business undertaken with banks that have increased their risk profile; some may increase collateral requirements for these banks. Similarly, depositors have an incentive to withdraw uninsured and partially-insured funds with banks that are considered unsafe. Ultimately, the market can refuse to enter into a new business with an unsound bank on any terms, preventing it from replacing maturing deposits and even from speedily liquidating assets, thus increasing the risk that the bank will be unable to meet its obligations as they fall due.

14. Importantly, disclosure helps prevent the occurrence of problems in banks. Enhanced public disclosure allows market discipline to work earlier and more effectively, thereby strengthening the incentives for banks to behave in a prudent and efficient manner. To the extent a bank's management knows its activities and risk exposures will be transparent, the various actions by market participants described in the preceding paragraphs, e.g., investment decisions and other business decisions, can provide a strong incentive for bank management to improve risk management practices and internal controls. Market discipline based on adequate public disclosure can, therefore, be an effective complement to supervisory efforts to encourage banks to maintain sound risk management systems and practices.

15. Apart from being a prerequisite for effective market discipline, there are other benefits of transparency to financial stability. Market disruptions are likely to be greater if the flow of information is irregular, with long periods of good or no news and sudden releases of negative information. If disclosure is ongoing, the mechanisms of market discipline can work earlier and more effectively. Timely public disclosure can reduce the severity of market

disturbances because market participants are informed on a more ongoing basis and therefore not as likely to overreact to information about current conditions.

16. Public disclosure can also help limit the systemic effects of market disruptions by increasing the ability of the market in times of stress to distinguish those banks that are vulnerable from those that are not. Banks that are prone to hide, or significantly delay, disclosure of problems are likely to be more exposed to market overreactions than banks that have a track record of prompt and balanced disclosures.

17. Furthermore, enhanced public disclosure can strengthen the control shareholders as a group can exercise over a bank's management by enabling a wider set of shareholders to participate effectively in the governance of the bank and by making the corporate governance process more transparent.

18. Moreover, public disclosure can reinforce specific supervisory measures designed to encourage banks to behave prudently, e.g., supervisory guidance on sound practice in risk management, by requiring banks to disclose whether or not they are in compliance.

19. Finally, adequate public disclosure facilitates a more efficient allocation of capital between banks since it helps the market accurately assess and compare the risk and return prospects of individual banks.

#### **(b) Effective public disclosure**

20. A number of issues need to be considered by supervisors and other public policy makers in designing effective disclosure standards. There are two broad goals. First, the information disclosed should result in appropriate transparency. Second, the market should respond appropriately to reward banks that are well managed.

##### ***(i) Achieving transparency***

21. There are inherent difficulties in making the riskiness of any enterprise transparent, including banks. For instance, in many countries the value of core banking activities, e.g., as they relate to credit risk and impairment inherent in the credit portfolio, cannot be estimated without some degree of imprecision. Therefore, the financial strength of a bank at any point in time and its financial performance over accounting periods, which are key inputs into any assessment of its riskiness, are subject to a certain degree of uncertainty. Furthermore, the risk appetite of a bank and the quality of its internal controls are crucial to the assessment of its riskiness, but may be difficult to communicate meaningfully, and, hence, difficult to make transparent.

22. Comparability of financial information across countries is also difficult to achieve, given that accounting and disclosure standards differ considerably not only for technical reasons, but also because of the interdependence between accounting, legal, fiscal and

political considerations.<sup>3</sup> Even when standards are similar, there may be considerable scope for interpretation and judgement when applying the principles. This may, of course, also lead to problems of comparability within countries.

23. Furthermore, it is clear that a bank, due to the need to preserve a degree of confidentiality, e.g., in relation to customers, cannot publicly disclose all data that may be relevant to an assessment of its activities and risk exposures. Privacy laws may restrict a bank's ability to disclose information on individual customers. Moreover, disclosure of detailed information on its individual customers and its risk management techniques and strategies, could significantly reduce the value to the bank of investing in these activities. Public disclosure standards should seek to balance the need for market participants to assess the quality of a bank's management with protecting the value to the bank of proprietary data.

24. Moreover, the usefulness of information depends on how current it is. Since banks' risk profiles can change rapidly, transparency requires the timely release of relevant information.

*(ii) Achieving market discipline*

25. The effectiveness of public disclosure as a means of promoting safety and soundness in banks also depends upon market participants taking measures that promote financial stability based on information disclosed. Sometimes such behaviour cannot be presumed.

26. For example, if shareholders, creditors and the market in general believe that governments will allow non-disclosure, partial disclosure, or even misleading disclosure should a bank run into difficulties, they are unlikely to consider publicly disclosed information credible. In these cases, market participants may seek to compensate for the lack of credible public disclosure by relying more on secondary sources of information, e.g., rating agency ratings, media and rumours.

27. In addition, the effectiveness of public disclosure on market discipline may be limited if market participants believe they are protected by an official "safety net". Also, public disclosure may have limited effectiveness in relation to banks with heavy reliance on retail deposits, since retail depositors may lack the training to monitor a bank's condition via its public disclosures. In some cases deposit insurance programmes may further limit certain depositors' incentives to withdraw funds from badly managed banks.

28. There may also be differences in risk tolerance among market participants, such as between creditors and shareholders. For example, if a bank is already on the brink of

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<sup>3</sup> The Basle Committee recognises that many international efforts are underway to improve the comparability of financial information across countries.

bankruptcy with its share capital eroded, shareholders may have an economic interest to tolerate or promote risky strategies, since they have little to lose should risky strategies fail, but a lot to gain if they succeed. Thus, shareholders would no longer react to information by providing disciplining incentives.

29. Furthermore, even if the market does apply appropriate discipline, its effect on the bank's behaviour depends upon the incentive structure within the firm. It is assumed that market discipline will result in shareholder pressure on the board to behave prudently, that the board will in turn provide incentives to executive management to behave prudently, and so on down the organisation. But there are potential weak links in this chain. For example, the ultimate sanction against management and employees – dismissal – may not match the severity of the ultimate sanction on shareholders – losses. This can provide management with an incentive to take inappropriate risk because of the potential benefit to their remuneration. Market conditions may be such that a bank must offer remuneration packages to management and staff that provide incentives which are not fully aligned with the bank's longer term financial health. Further, generous severance payments to senior executives may also reduce the incentives to behave prudently.

30. Several of the factors influencing the market's response to public disclosure have their origin in policy trade-offs in the design of the institutional framework underlying capital markets and banking business. Since market discipline requires that some depositors, lenders or investors have an economic incentive to favour safe and sound banks, arrangements that limit stakeholders' exposure to risk will reduce the effectiveness of market discipline.

### **(c) Potential drawbacks of public disclosure**

31. In promoting transparency, supervisors and other public policy makers need to take into account the potential drawbacks that public disclosure can have in certain circumstances. Private and public interests may not always coincide. In particular, when the market becomes aware that a bank is in a weakened position it may react more harshly than is desirable from the point of view of the authorities who have responsibilities for depositors' protection and for managing systemic risk. In the absence of irrevocable liquidity facilities or arrangements, the bank may fail as a result of a liquidity crisis, even if it is solvent in terms of net assets. The market's lack of confidence in a bank may spread to other banks, leading to a systemic disturbance. However, in an environment of adequate ongoing disclosure, the likelihood of this kind of contagion is less likely. Moreover, in many countries banks are already required to disclose substantial information about their financial condition, performance, risk profile and risk management in their annual reports, and most stock exchange rules require listed banks to disclose market-sensitive information promptly.

32. The fact that disclosure may cause problems when a bank is in a weak condition does not refute the proposition that disclosure provides incentives for healthy banks to

continue conducting their operations in a sound and efficient manner. Moreover, as noted earlier, disclosure will likely cause correction of problems at an earlier stage. Finally, some argue that a bank's disclosure of negative information can even have a positive impact on the market's evaluation of a bank if it increases the credibility of its management, as evidenced by its forthright disclosures, thereby improving the market's confidence in the bank.

33. Another potential drawback of public disclosure is the cost involved. It is often difficult to assess whether the benefits of additional disclosure outweigh the costs. One reason is that the direct costs of producing and providing information, i.e., the incremental cost of developing, implementing and maintaining a system to generate the required disclosures and their publication, are not borne by the potential users that may derive benefits from improved disclosure. While policy-makers often take for granted the net benefits of additional disclosure, some studies indicate that disclosure requirements can, in some cases, impose substantial costs. Nevertheless, within well-managed banks, information that is relevant should already be available internally and used by management to operate the business.

### **3. THE ROLE OF SUPERVISORS IN IMPROVING TRANSPARENCY**

34. The Basle Committee believes that there are significant benefits of transparency from a supervisory point of view as well as from a financial stability perspective. Consequently, it encourages legislators, banking supervisors and other standard-setters to focus their efforts on promoting ongoing, high-quality public disclosure at reasonable cost. There are various ways in which supervisors can help strengthen transparency by promoting improved public disclosure.

#### **(a) Supervisors' role in setting and influencing disclosure standards and practices**

35. To achieve the maximum benefit of public disclosure, it is in the interest of supervisors and other public policy makers to pursue policies that promote comparability, relevance, reliability and timeliness of the information disclosed. Ongoing, high-quality disclosure improves market participants' ability to distinguish banks with high risk from those that are fundamentally safe and sound, and enables market discipline to work earlier and more effectively.

36. Regulators and other standard-setters, including banking supervisors in some countries, issue disclosure standards and guidelines to promote a satisfactory level of transparency and comparability. Even in the absence of competence to set standards, banking supervisors can play an important role by contributing to, and influencing, the debate on

improvement in disclosure principles and practices. This has been demonstrated in the Basle Committee's own work in promoting enhancements in trading and derivatives disclosures.<sup>4</sup>

37. In particular, supervisory authorities can take a leading role by encouraging the use of supervisory definitions and reporting classifications for public disclosure purposes. Supervisory reporting systems typically contain harmonised banking information and employ a uniform technical language, facilitating comparison of data. For instance, and as recommended in the joint Basle Committee/IOSCO report on trading and derivatives disclosure, banks can use the joint Basle Committee/IOSCO supervisory information framework as a baseline for the types of information about derivatives that can be provided for public disclosure purposes.<sup>5</sup> Supervisory guidance can also facilitate industry agreement on harmonised disclosure standards and practices by alleviating co-ordination problems that banks face in agreeing privately on common standards. The contribution of supervisory authorities to improved disclosure would help minimise the cost of transparency for the banking system and speed up the process of disclosure convergence, which, in the absence of external stimulus, may be lengthy.

38. Due to the need to strike a balance between the general interest and the costs borne by firms, supervisory authorities should consult with representatives of the banking industry and accounting profession in developing disclosure standards and guidance. Such co-operation is crucial for the definition of standards that are satisfactory, generally accepted and likely to minimise the risk of exaggerated reaction that could cause confidence crises in periods of stress.

#### **(b) Supervisory authorities' disclosure of information on banks**

39. In many regulatory frameworks, banks transmit to supervisory authorities, on the basis of a relationship covered by professional secrecy laws and rules, a larger amount of accounting data and other information than they are legally required to make public (e.g., annual reports) or that they publish voluntarily (e.g., in the press).

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<sup>4</sup> "Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms" (November 1995) and "Survey of Disclosures about Trading and Derivatives Activities of Banks and Securities Firms" (November 1996 and November 1997). These reports include recommendations for further improvements in disclosure practices of large banks and securities firms. They were prepared in collaboration with the Technical Committee of the International Organisation of Securities Commissions (IOSCO).

<sup>5</sup> "Framework for Supervisory Information about Derivatives and Trading Activities" (first issued in May 1995, updated in September 1998). The paper presents a catalogue of data on derivatives activities and risks that supervisors can use to enhance the information reported to them, and a common minimum framework of data elements on exchange-traded and OTC derivatives to which supervisors should have access. It was prepared in collaboration with the Technical Committee of the International Organisation of Securities Commissions (IOSCO).

40. Supervisory authorities can use this important stock of information not only to perform the tasks entrusted to them by law, but also to enrich the information available to the public. Confidentiality obligations mean that information usually has to be released in aggregate form.<sup>6</sup> The way in which supervisory authorities make the data available to the public can be chosen from a range of options. For example, they can release an aggregation of the data banks transmit, taking account of the different transaction categories (classified by currency, maturity and customers' geographical location and sector, etc.). They can use more sophisticated treatments involving balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, risk profiles, etc.).

41. The importance of improving the operation of markets through greater transparency raises the question of whether supervisory authorities should also make information available on individual banks and/or make public their assessment of the balance sheet and profitability of the banks they supervise. Making public all information that supervisory authorities obtain or produce on individual banks does not appear advisable, for reasons connected with the stability of the banking system, efficiency and materiality, and on grounds of confidentiality. Further, it may be prohibited by law. Supervisory authorities' tasks are not only to know and assess banks' performance, but also to prevent and cope with difficult situations in compliance with the mandate to safeguard the stability of the banking system. It would appear contrary to this mandate to release all information on supervisory assessments of individual banks and their plans for the resolution of individual banks' problems. Potential market overreactions and contagion effects could frustrate efforts of the authorities to restore conditions of sound and prudent management in a bank with problems. Further, it could undermine the ability of supervisory authorities to make independent judgements because of concerns about the effects of their decisions on the market. Finally, it could become more difficult for supervisory authorities to obtain confidential information from banks owing to the latter's fear of its possible subsequent publication.

42. However, the need for information can, in part, be met if banks make certain supervisory-related information available in response to legal or other requirements or as a result of decisions taken voluntarily by management.

**(c) Supervisors' review of compliance with disclosure standards**

43. Another way in which supervisors can strengthen transparency is by instituting effective review and enforcement mechanisms designed to ensure compliance with disclosure standards. The credibility of public disclosure suffers if a bank concealing negative

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<sup>6</sup> In some countries, supervisors release some information they have on individual institutions, such as periodic regulatory financial statements and off-balance-sheet exposures.

information or providing misleading information is not effectively sanctioned. In some countries, supervisors, securities regulators, and other regulatory authorities already conduct regular reviews of the quality of public disclosure of banks and take action against banks that provide insufficient or misleading disclosures, e.g., by initiating discussions with these banks, by informing the public, or by imposing monetary fines on the bank.

44. A key means of ensuring reliable information within banks is sound and comprehensive internal control and risk management systems, complemented by effective internal audit activities. In addition, assurance about the reliability of disclosed information can be enhanced through audit by independent external auditors. Therefore, supervisors should, in addition to measures to promote strong internal controls and risk management practices within banks, encourage ongoing improvement in auditing standards, ethics and practices.

#### **4. SUPERVISORY INFORMATION NEEDS**

45. In addition to having a role in establishing adequate disclosure standards, supervisors are also users of information provided by banks. Effective banking supervision requires collection and analysis of information to assess the condition, performance and risk profile of individual banks and the condition of the banking system. While section 2 provided an elaboration of the role of information in facilitating market discipline, this section discusses the role of information in prudential supervision.

46. Supervisors receive information in a variety of ways. First, supervisors are key users of information that is publicly disclosed and contained in annual reports, analysts' ratings and assessments. Second, in most countries, the supervisory authority has the power to set regular reporting requirements, and this information is routinely sent to supervisors. This information is important to supervisors in enhancing publicly disclosed information, due to its timeliness, proprietary character or adaptation to specific supervisory information needs. Further, supervisory authorities collect data during the on-site examination process or external audit process. This information is used alongside publicly disclosed information and information that has been reported to the supervisor to obtain a comprehensive and forward-looking picture of the bank's condition, operations, risk profile and risk management activities. Supervisors may also gather information by conducting targeted examinations, audits or surveys. Finally, supervisors also have access to the information that the bank itself possesses.

47. Supervisors use different combinations of these methods for gathering information, depending on the nature of the data, the number of institutions under review, their size and complexity, and the characteristics of the market and the regulatory framework. Regardless of the method used and the mix among them, it is essential that banking supervisors obtain information that enables them to detect potential problems at an early stage and identify trends

not only for particular institutions, but also for the banking system as a whole. Generally this will involve some form of reporting procedure.

48. While this document recommends that supervisors proactively encourage improvements in public disclosure standards, supervisors' first priority in countries with less developed financial markets must be to establish a comprehensive supervisory reporting system. For banks with little or no reliance on active and competitive markets, market discipline can only play a very limited role.

49. Banking supervisors use supervisory reports in a variety of ways. First, they are used to check banks' adherence to prudential requirements, such as capital adequacy and large exposures, and to identify potential problems. To enable effective off-site supervision, banking supervisors must receive financial information at regular intervals, and this information must be verified periodically through on-site examinations or external audits. Information of interest to supervisors may, of course, include public information, but regular supervisory reporting will typically encompass information that is not publicly disclosed, e.g., more detailed and timely data and proprietary information. Banks should be required to make information available on a periodic basis for review by supervisors, and inform supervisors of important matters in a timely manner. Supervisory reporting systems should provide for early detection in the intervals between on-site examinations, external audits, or supervisory visitations, enabling supervisors to take prompt action before problems become more serious.

50. To minimise additional costs on the industry, supervisors should, where appropriate, use information that banks generate for internal purposes. Moreover, there should be as much consistency as possible between information obtained for reporting purposes and data that institutions must already compile to comply with other supervisory or public disclosure requirements. Finally, supervisors should assess their information needs periodically to determine whether certain reporting requirements can be eliminated.

51. A minimum level of harmonisation of supervisory information across countries, taking account of what data is already produced for internal risk management purposes and public disclosure requirements, would also help limit the reporting burden for the banking industry. To that end, the Basle Committee, jointly with IOSCO, issued in 1995 a Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms, including a common minimum framework of data elements on exchange-traded and OTC derivatives to which supervisors should have access. In 1998, the Framework was updated to keep pace with financial innovation and progress in risk management practices for trading and derivatives activities, particularly with regard to market risk.

52. The characteristics and types of information addressed in the following sections of this report, while often discussed in the context of public disclosure, are also very important for supervisory purposes. These characteristics and types of information are necessary to

assess and understand a bank's financial condition and performance, risk profile, risk management practices, and corporate governance. Therefore, supervisory information should reflect the qualitative and quantitative attributes discussed in the following sections.

## **5. QUALITATIVE CHARACTERISTICS OF TRANSPARENT INFORMATION**

53. This paper defines transparency as public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, its business activities, and the risks related to those activities. In this section, critical qualitative characteristics of information that contribute to bank transparency are further elaborated. These characteristics<sup>7</sup> are:

- comprehensiveness;
- relevance and timeliness;
- reliability;
- comparability;
- materiality.

### **(a) Comprehensiveness**

54. To enable market participants and other users of information to make meaningful evaluations of banks, information should be comprehensive. This often implies the aggregation, consolidation and assessment of information across a number of activities and legal entities.

55. Where institutions undertake business activities that fall under the jurisdiction of different supervisors, or where certain affiliates are not supervised, supervisors should discuss with regulated firms how best to obtain information that provides a comprehensive, timely picture of the risks associated with their overall activities. Bank supervisors should attempt to obtain information about these activities on a consolidated basis, while recognising the legal distinctions among subsidiaries and the need to receive summary information about major business activities and key entities within a consolidated banking group.

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<sup>7</sup> These concepts are discussed in accounting literature and national and international accounting guidance. For example, International Accounting Standard (IAS) No. 1 (revised 1998), IASC Framework for the Preparation and Presentation of Financial Statements, Canadian Institute of Chartered Accountants (CICA) Handbook Section 1000 on Financial Statement Concepts, UK Accounting Standards Board's Exposure Draft Statement of Principles for financial reporting, U.S. Financial Accounting Standards Board's (FASB) Statements of Financial Accounting Concepts No. 2 and 5, and certain provisions in the EU Accounting Directives.

**(b) Relevance and timeliness**

56. To be useful, information must be relevant to the decision-making needs of users. Information is relevant to market participants when it helps them assess the expected risks and returns of investing in, lending to, or having other exposures to a bank and its future financial performance and position. Information is relevant to supervisors when it helps them assess the safety and soundness of a bank's operations.

57. To be relevant, information also needs to be timely. Information should be provided with sufficient frequency and timeliness to give a meaningful picture of an institution, including its risk profile and risk management performance.

**(c) Reliability**

58. Information must also be reliable. In particular, information should faithfully represent that which it purports to represent, or could reasonably be expected to represent. Further, to be reliable it must reflect the economic substance of events and transactions and not merely their legal form, be verifiable, neutral (i.e., free from material error or bias), prudent, and complete in all material respects. Completeness within the constraints of materiality and cost is of particular importance, since an omission can cause information to be false or misleading.

59. In some instances, banks may have to balance the interests of relevance and reliability. For example, forward-looking information, such as earnings predictions, may score highly on relevance but lack reliability, while the reverse is more likely to apply to historical information. Moreover, given the fact that banks are now able to rapidly change their risk profiles, timeliness is critical for relevance. However, one of the main methods for ensuring reliability - external audit - tends to delay the release of information.

**(d) Comparability**

60. Another essential characteristic of information is comparability. Supervisors, market participants and other users need information that can be compared across institutions and countries, and over time. This implies that a bank should use consistent accounting policies and procedures from period to period, and uniform measurement concepts and procedures for related items. Changes in accounting policies and procedures should not be made unless they can be justified as being more appropriate, e.g., because of a change in accounting standards. However, when accounting policies are changed, these changes, and their effects, should be disclosed. Comparability in information across banks and across countries enables users to assess the relative financial position and performance of banks against other banks. Comparability over time is necessary for the identification of trends in a bank's financial position and performance. To facilitate the identification of trends, financial

reporting should provide comparative figures in respect of one or more previous periods for numerical information.

**(e) Materiality**

61. Banks' financial reports should present or disclose each material item separately. Information is material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Information that is not disclosed because it is immaterial may, nevertheless, be relevant for internal risk management purposes and in supervisory assessments. Information of this nature should be available within regulated firms and their material affiliates, and should be accessible to supervisors.

**6. RECOMMENDATIONS FOR ENHANCING BANK TRANSPARENCY**

62. The Basle Committee recommends that banks, in regular financial reporting and other public disclosures provide timely information which facilitates market participants' assessment of banks. It has identified the following six broad categories of information, each of which should be addressed in clear terms and appropriate detail to help achieve a satisfactory level of bank transparency:

- financial performance;
- financial position (including capital, solvency and liquidity);
- risk management strategies and practices;
- risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks);
- accounting policies; and
- basic business, management and corporate governance information.

63. The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and nature of a bank's operations. Further, the methods of measurement will depend on applicable accounting standards.

64. The task of assessing banks is also an integral part of prudential supervision, and therefore the Basle Committee encourages supervisors to have access to adequate and timely information with respect to the six areas identified above. Supervisors may want to obtain some of the information in more detail than is normally provided for financial reporting purposes. In countries with less developed financial markets, supervisors may need to establish a more comprehensive supervisory reporting system covering these six broad categories of information to compensate for inadequacies in publicly disclosed information.

65. These recommendations are at a very general level. Within each broad area, significant detail in disclosures may be required, depending in part on the institution's activities. The Basle Committee may offer more specific guidance in some of these areas in the future. As previously mentioned, the Basle Committee, jointly with the Technical Committee of IOSCO, has already issued more detailed disclosure recommendations for the trading and derivatives activities of large banks and securities firms.

**(a) Financial performance**

66. Both market participants and supervisors need information about the financial performance of a bank. Information about the performance of a bank, in particular about its profitability, and the variability of those profits over time, is necessary to assess potential changes in financial position and future potential to repay deposits and liabilities, to make distributions to owners, and to contribute to capital growth. Information about profits and losses and their components over recent and earlier periods, helps form assessments of future financial performance and cash flows. It also helps assess the effectiveness with which a bank has employed its resources. Useful information includes basic quantitative indicators of financial performance, breakdowns of income and expenses, and management's discussion and analysis of financial performance.

67. To assess the financial performance of a bank, it is essential to have a breakdown of income and expenses incurred. This information is necessary to assess the quality of earnings, to identify the reasons for changes in a given bank's profitability from year to year and to compare the financial performance of different banks. Information on financial performance typically includes an income statement that groups income and expenses by nature or function within the bank. The income statement usually includes items for interest income and expense, fees and commissions, other non-interest income, operating expenses, charge for credit losses, any extraordinary items, tax expenses and net income. The notes to the income statement provide additional detail on important income and expense categories. For the purpose of assessing sustainability of profits, it is essential that the impact of acquisitions and lines of business discontinued during the year be disclosed. Key figures and ratios should include the return on average equity, return on average assets, net interest margin (net interest income divided by average interest earning assets), and cost-to-income ratio.

68. Business and geographical segment information aids in the analysis of past performance and assists in assessing future prospects. The user of financial information can achieve a better understanding of a bank's overall financial performance if the bank discloses the contribution of different activities and regions to overall financial performance. In particular, this information helps the user assess the extent of diversification in the bank's business and the contribution of specific business segments and regions that may be

considered to be of a higher risk. It also facilitates awareness of the impact of significant changes, e.g., due to regional disturbances, on the bank as a whole.

69. Management has a detailed knowledge of the business that outsiders cannot have. Therefore, management can greatly assist both the market and supervisors by discussing the main factors that influenced a bank's financial performance for the year, by explaining differences in performance between the current year and previous years and by discussing factors they believe will have a significant influence on the bank's future financial performance.

70. In many countries, comprehensive accounting guidance is available on the presentation and disclosure of information about financial performance. Authoritative guidance has been issued by legislators, regulators, and national and international accounting standard-setters, and should be referenced to identify appropriate disclosures and to gain an understanding of why they are useful.

**(b) Financial position (including capital, solvency and liquidity)**

71. Market participants and supervisors need information about the financial position of an institution. Information about the financial position of a bank is useful in predicting the ability of the enterprise to meet its liabilities and financial commitments as they fall due. Information about the nature and amount of assets, liabilities, commitments, contingent liabilities, and shareholders' funds, both at points in time and averages over periods, including their maturity and repricing structure, is useful for assessing a bank's liquidity and solvency, and ultimately its financial strength, and the trends therein. Information about institutions' provisions and allowances for losses and how these provisions and allowances are determined is important in assessing an institution's ability to withstand losses.

72. To assess an institution's financial position, it is essential to have a breakdown of assets and liabilities, and equity capital by type. Information on financial position typically includes a balance sheet that distinguishes different types of assets, liabilities and sources of equity capital. The balance sheet usually includes separate items for loans, trading securities, investment securities, tangible fixed assets (e.g., real estate), intangible fixed assets (e.g., goodwill), short-term debt and long-term debt. Disclosure of off-balance-sheet items may include information about notional amounts and fair values or replacement values of off-balance-sheet transactions, and about commitments and contingent liabilities. In notes to the balance sheet, additional information about the items in the balance sheet which is relevant to the needs of users may also be provided, e.g., fair value (trading account, loans, deposits, others).

73. Moreover, information about regulatory capital and its components is important in analysing the financial position of a bank (tier 1, tier 2, tier 3 – if applicable, risk-weighted

assets, risk-based capital ratio), as well as information about equity capital (e.g., debt-to-equity ratio, restrictions on distributions). Information about the changes in the amount and types of capital, including the impact of earnings, dividends and capital issuances, is important in assessing the cushion available to absorb future potential losses and for the bank's ability to sustain growth over the near term. Management's discussion and analysis of a bank's financial position and changes therein, help the market better understand and form expectations based on them.

74. Information about the nature and amount of assets pledged as collateral, e.g., to support deposits, other liabilities and commitments, and the amount of secured liabilities is useful in assessing the financial position of a bank and, in particular, the collectibility of claims on the bank in case of its liquidation.

75. As with guidance on presentation and disclosure of financial performance, comprehensive accounting guidance on the presentation and disclosure of information about financial position is available in many countries. Authoritative guidance has been issued by legislators, regulators, and national and international accounting standard-setters.

**(c) Risk management strategies and practices**

76. Market participants and supervisors need information about a bank's management strategies and policies for managing and controlling risks. Risk management is a key factor in assessing the future performance and condition of a bank and the effectiveness of management.

77. Disclosures may include discussions of overall risk management philosophy, overall policy and methodologies, how risks arise, how risks are managed and controlled, and whether and how derivatives are used to manage risks. It may also be useful to discuss the risk management structure and risk measurement and monitoring (e.g., models, value-at-risk, simulation, credit scoring, capital allocation, etc.), monitoring process, model validation process, stress testing, back testing, the use of risk-mitigating tools (collateral/guarantees, netting agreements, managing concentrations), limits (e.g., credit limits, market risk limits), and periodic review of exposures.

78. It is a particular challenge for a bank to maintain transparency as risk management methods advance. Banks should strive to continue to provide meaningful information so the public understands the risk management techniques and measures used over time.

79. In addition to overall risk management strategies, individual discussions of risk exposures need to include specific risk management strategies. This is elaborated upon in the next section.

**(d) Risk exposures**

80. Market participants and supervisors need qualitative and quantitative information about an institution's risk exposures, including its strategies for managing risk and the effectiveness of those strategies. Together with the disclosure of a bank's financial position, these help reflect its financial strength and viability and ultimately its ability to continue its business in times of stress. A bank's risk profile, i.e., the risks inherent in its on- and off-balance-sheet activities at a point in time and its appetite for taking risk, provides information about the stability of an institution's financial position and the sensitivity of its earnings potential to changes in market conditions. Moreover, an understanding of the nature and extent of an institution's risk exposures helps assess whether a bank's returns are appropriate for the level of risk it has assumed.

81. Disclosures of risk information assist in assessing the amount, timing and certainty of future cash flows. Given the dynamic financial markets in which banks operate, and the influences of increased global competition and technological innovation, a bank's risk profile can change very quickly. Therefore, users of financial information need measures of risk exposures that remain meaningful over time and which accurately reflect sensitivities to changes in underlying market conditions.

82. Traditionally, banks have focused on disclosing information about credit risk and market risk, including interest rate and foreign exchange risk, and, to a lesser extent, liquidity risk. In discussing each of these risk areas, an institution should present sufficient qualitative (e.g., management strategies) and quantitative information (e.g., position data) to help users understand the nature and magnitude of these risk exposures. Further, comparative information of previous years' data should be provided to give the financial statement user a perspective on trends in the underlying exposures.

83. Other risk exposures such as operational, legal and strategic risk are less easy to quantify, but may be highly relevant. Qualitative information should be given about the nature of the risks and how they are managed.

**(i) Credit risk**

84. For many institutions, credit risk is the most significant exposure. Although typically it arises primarily from the loan portfolio, credit risk also arises in the investment and trading portfolios and in other banking activities (e.g. asset securitisation, interbank lending, overnight deposits).

85. Disclosures should help the reader understand the magnitude of an institution's credit exposure on an aggregate basis as well as its significant components. Further, the user of financial information should be able to understand how an institution manages credit risk and whether or not those strategies have been effective.

86. To achieve transparency, an institution should provide descriptive information about the business activities that create credit risk, its strategies regarding those business lines, and the nature and composition of the exposures that arise. Examples of useful disclosures include a discussion about business strategies, risk management processes and internal controls relating to activities that generate credit risk. In addition, quantitative information should be provided regarding gross positions (e.g., loans, investments, trading and off-balance-sheet exposures), information about the types of counterparties (e.g., exposure to banks, commercial, and government entities; domestic and international exposures; subordinate assets, and secured and unsecured exposures), and significant concentrations of credit exposure. Further, information on potential credit risk exposure arising from existing derivative contracts is useful, since that exposure may change rapidly and substantially.

87. Disclosures about the quality of the current loan and investment portfolios and other significant counterparty exposures provide important information about an institution's future earnings potential. Quantitative disclosures should include the amount of problem loans and other assets, an ageing schedule of past due loans and other assets, concentrations of credit, and aggregate exposures by counterparty credit quality. In addition, information should be provided about the allowances for credit losses and how those allowances have changed from period to period.

88. An understanding of an institution's credit risk position is facilitated through disclosure of risk management strategies. For example, disclosures about the use of collateral and guarantees, the use of credit scoring and portfolio risk measurement models and the organisation of the credit risk function and similar discussions about activities undertaken to manage credit exposures provide background information useful in assessing the significance of risk exposures. Information about the use of credit limits and internal credit ratings is also useful.

**(ii) Market risk**

89. As with credit risk, an institution should provide both quantitative and qualitative information regarding its market risk exposures. Market risk arises from the potential for changes in market rates and prices, including interest rates, foreign exchange rates, and equity and commodity prices. An institution's disclosures about each of these types of risk should be commensurate with the degree of exposure.

90. Since *interest rate risk* is especially relevant to banks, management should provide detailed quantitative information about the nature and extent of interest rate-sensitive assets and liabilities and off-balance sheet exposures. Examples of useful disclosures for the banking book include breakdowns of fixed and floating rate items and the net interest margin earned. Other useful disclosures include the duration and effective interest rates of assets and

liabilities. These disclosures should also identify assets and liabilities, and related gains and losses.

91. Disclosures should also provide information about the interest rate sensitivity of an institution's assets and liabilities. For example, disclosures about the effect on the value of assets, liabilities and economic equity given a specific change (increase or decrease) in interest rates can provide a useful summary measure of the institution's risk exposure.

92. To facilitate understanding of *foreign exchange risk* exposures, institutions should provide summarised data for significant concentrations of foreign exchange exposure by currency, broken down by hedged and unhedged exposures. It is also helpful to disclose information about investments in foreign subsidiaries (foreign currency translation risk). This quantitative information should be supplemented with discussion about the nature of the currency exposure, how that exposure has changed from year to year, foreign exchange translation effects, the earnings impact of foreign exchange transactions and the effectiveness of risk management (hedging) strategies.

93. For larger institutions, "value-at-risk" (VAR) or "earnings-at-risk" (EAR) disclosures can provide summarised data about a market risk exposure. Typically, VAR and EAR disclosures are provided for interest rate and foreign exchange risk, but these models could also be used to summarise equity and commodity risk exposures. Specific disclosures relating to these models include the magnitude of the exposure on a daily, weekly or monthly basis, maximum and minimum values, and end-of-period values. To help the user understand such model-generated information, the assumptions used in calculations (e.g., confidence level, holding period, etc.) should also be disclosed. In addition, a histogram of the daily profits or exposures over the reporting period may facilitate an understanding of the volatility of risk exposures.

### *(iii) Liquidity risk*

94. Liquidity is the ability to have funds available to meet the commitments of the bank. To enable market participants to understand an institution's liquidity risk exposure, an institution should provide information about its available liquid assets, as well as its sources and uses of funds. For example, disclosures about short-term assets (e.g., cash and cash equivalents, repurchase agreements and interbank loans) and short-term liabilities (e.g., reverse repurchase agreements, commercial paper) provide basic information about an institution's liquidity profile. A cash flow statement shows the sources and uses of funds and provides an indication of an institution's ability to generate liquid assets internally. Information about concentrations of depositors and other fund providers, maturity information about deposits and other liabilities, and the amount of securitised assets, are useful in assessing an institution's liquidity. Descriptive discussion about the diversity of funding

options and contingency plans provides additional perspective on the potential impact of liquidity risk to the institution.

***(iv) Operational and legal risks***

95. Institutions should also provide disclosures about operational and legal risks. Operational risk disclosures should include information about the main types of such risk and should identify any specific problem (e.g., Year 2000) considered to be individually significant. Legal risk disclosures include legal contingencies (including pending legal actions) and a discussion and estimate of the potential liabilities. Qualitative information about how the bank manages and controls these risks should be given.

**(e) Accounting policies**

96. Market participants and supervisors need information about the accounting policies that have been employed in the preparation of financial reports. Accounting policies, practices and procedures differ not only between countries, but also between banks in the same country. Accordingly, users of accounting information need to understand how items are being measured to properly interpret the information. Disclosure of significant accounting policies on which financial reporting is based enables users to make reliable assessments of the bank's reported position and performance.

97. Disclosure of accounting policies may be appropriate with respect to general accounting principles, changes in accounting policies/practices, principles of consolidation, policies and methods for determining when assets are impaired, recognising income on impaired assets and losses on non-performing credits, policies to establish specific and general loan loss allowances, income recognition, valuation policies (trading securities, investment securities, loans, tangible fixed assets, intangible fixed assets, liabilities, etc.), recognition/derecognition policies, securitisations, foreign currency translations, loan fees, premiums and discounts, repurchase agreements, securities lending, premises/fixed assets, income taxes, and derivatives (hedging, non-hedging, losses on derivatives).

**(f) Basic business, management and corporate governance information**

98. To accurately evaluate a bank's disclosures about its financial position and financial performance and its risks and risk management strategies, market participants and supervisors need fundamental information about the bank's business, management and corporate governance. Such information can help provide the appropriate perspective and context to understand a bank's activities. For example, management's discussion about the bank's position in the markets in which it competes, its strategy and its progress towards achieving its strategic objectives is important for assessing the bank's future prospects.

99. The organisation of a bank, in terms of both its legal and management structure, provides information about an institution's key activities and its ability to respond to changes in the marketplace. Further, such information may provide an indication of the institution's efficiency and overall strength. Accordingly, it is appropriate to disclose information about the board structure (e.g., the size of the board, board committees, and membership), senior management structure (responsibilities, reporting lines), and the basic organisational structure (line of business structure, legal entity structure). In addition, information should be provided about the qualifications and experience of the board and senior executives. This information may be helpful in assessing how an institution may perform in times of stress or how it may react to changes in the economic or competitive environment.

100. Information about the incentive structure within a bank, including its remuneration policies, such as the amount of executive compensation and the use of performance bonuses and stock options, helps evaluate the incentives management and staff have to take excessive risks. Useful information may include a summary discussion of the philosophy and policy for executive and staff compensation, the role of the board of directors in setting compensation, and compensation amounts.

101. In addition, banks should provide information on the nature and extent of transactions with affiliates and related parties. Such information is useful in identifying relationships that may have a positive or negative impact on a bank's financial position and performance. Further, it can help assess its susceptibility to the effects of affiliates on the bank's financial performance (contagion risk).

102. Finally, institutions should consider providing general information that would help market participants and supervisors gain a broad understanding of the institution's culture. As indicated previously, banks should be innovative in identifying the types of information they provide and the methods by which they provide such data.

## **7. CONCLUSION**

103. The Basle Committee considers bank transparency to be of the utmost importance. Financial market players can reinforce the efforts of bank supervisors if they have access to timely and reliable information which enables them to assess a bank's activities and the risks inherent in those activities. Toward this end, banks and bank supervisors need to ensure that appropriate disclosures are being made.

104. To achieve transparency a bank, in its financial reports and other disclosures to the public, should provide timely information on key factors affecting market participants' assessment of banks. This paper sets forth the following six broad categories of information, each of which should be addressed in clear terms and appropriate detail to help achieve a satisfactory level of bank transparency:

- financial performance;
- financial position (including capital, solvency and liquidity);
- risk management strategies and practices;
- risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks);
- accounting policies; and
- basic business, management and corporate governance information.

105. In the paper, specific examples of useful information within each category are provided. Supervisors and public policy makers should focus their efforts on promoting high-quality disclosure standards, taking into consideration the recommendations presented in this paper, and on developing mechanisms that ensure compliance with those standards.

106. The Basle Committee considers transparency to be a key element of an effectively supervised, safe and sound banking system. The Committee will continue to promote transparency, including by developing more detailed disclosure guidance in some of the areas identified in this report.