

Jaime Caruana: Reflections on financial information from the standpoint of a banking supervisor

Speech by Mr Jaime Caruana, Governor of the Bank of Spain, at the 13th XBRL International Conference, Madrid, 16 May 2006.

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Introduction

Good afternoon.

I would like to begin by thanking the organisers of this 13th XBRL International Conference for their kind invitation to participate. I am delighted to have this opportunity to close today's session by sharing with you some reflections on financial information from the standpoint of a banking supervisor. And it is, of course, a special pleasure for me to be able to address this audience in my home country.

I guess that, looking from the outside, it might seem somewhat strange that banking supervisors and other regulators are taking such an active interest in a computer language. But I think that all of us here are very well aware of the role that tools such as XBRL can play in promoting the effective and efficient flow of financial information, and it is on this wider objective that I want to focus my intervention today.

I will begin with a brief introduction to recall the important role that information plays in financial markets from a macroeconomic perspective. But I would like to devote the main part of my presentation to five initiatives that I believe regulators - as one of the sources of information demands on the industry - can take to contribute to ensuring that financial information can be generated, transmitted and used in the most efficient and effective way, to the benefit of stakeholders and interested parties, in today's complex financial markets. In doing so, I will draw on my experience as the Governor of an EU central bank with prudential supervisory responsibilities, and also as the current Chairman of the Basel Committee on Banking Supervision.

The importance of financial information

So, why is information so important? Quite simply, because information is the fabric from which financial markets are made. Let me elaborate on this statement.

In economic terms, an efficient market is defined as one in which prices reflect all available information. Extrapolating this, we can say that the efficient functioning of financial markets requires that the prices within those markets reflect all the information on the financial asset being traded. For markets to be efficient, therefore, it is necessary that sufficient information flows with sufficient speed.

However, information is neither created nor transmitted spontaneously. First, it must be generated. Then, it must be transmitted to users, through the appropriate channels and in the appropriate format and presentation. These users, in turn, must incorporate the information into their own decision-making processes. This is a process which clearly implies costs, both in terms of time and resources.

Regulators are one of the stakeholders in this process. In order to fulfil our objectives and functions, we need information from the entities and markets that we supervise. But financial institutions are faced with requirements from other sources too. They have to produce information for a whole range of other purposes, for example to fulfil mercantile, fiscal and statistical requirements, as well as to run their own business, of course.

On top of this, changes in the financial markets themselves are having a major impact on information flows. Increases in the complexity and volume of financial transactions are contributing to an increase in the complexity and volume of information that entities need to produce and manage, even if only for their own internal purposes. And if we add in the ever more prevalent international dimension, the situation becomes even more complicated.

In the face of these developments, it seems important to me that we find new ways to manage the information process.

So what can we do, as regulators, to promote the most effective and efficient processes for the generation, transmission and use of financial information, and therefore the most efficient markets? I

believe there are five key elements in this process, and it is on these elements that I will focus in the remainder of my intervention.

1 Convergence of regulatory requirements

The first of these involves starting at the beginning of the value chain of information requirements. In my view, a greater degree of convergence in the underlying regulation which applies to financial institutions and markets will provide us with an excellent basis for making progress on other aspects. Let me refer to some initiatives that have been taken in this respect.

Of course, the first initiative that I must mention is that of International Financial Reporting Standards (IFRS). Given the importance of accounting data as the basis of information flows, the development and application of these standards is providing a valuable opportunity to enhance the efficiency and comparability of information, especially on an international basis.

Indeed, with effect from 1 January 2005, all EU listed companies have been required by law to use IFRS for their consolidated financial statements. The significance of this development should not be underestimated. It means that market participants and other interested parties should be able to compare and contrast information relating to companies in different jurisdictions on a like-for-like basis, and thereby make more informed decisions. Common accounting standards increase transparency and comparability for investors, thus promoting greater cross border investment.

And let me give you a less direct, but nonetheless important example of a regulatory convergence initiative, from my perspective as Chairman of the Basel Committee on Banking Supervision. As you may well be aware, at the end of the nineties, we embarked on a review of the so-called "Basel Accord", an agreement reached back in 1988 to determine minimum regulatory capital requirements for international banks. The result of this review, the new "Basel II" framework, will, like its predecessor, be applied not only in the thirteen countries which are members of the Committee, but in many other countries of the world, including the 25 countries of the European Union – in fact, in probably more than 100 countries in total.

And Basel II is much more than a capital requirements regime. It is a major shift in regulatory philosophy. First, although it still sets minimum capital requirements, these are based on a menu of approaches with built-in economic incentives to encourage banks to develop and use more sophisticated risk measurement and management systems which can be recognised for supervisory purposes. Second, banks are encouraged to conduct their own assessments of their overall risk profile in order to determine whether they need additional capital buffers and/or other risk mitigants. Supervisors will evaluate these assessments and both parties will engage in dialogue on the basis of their findings. Thirdly, the new regime sets out requirements for increased transparency and disclosure by institutions to the markets. This is intended to leverage the ability of markets to provide discipline to banks to ensure that they are not holding unrealistically low levels of capital.

In sum, Basel II will have wide-ranging effects, both on banks and on supervisors, across many countries. Many aspects of the supervisory process which are currently subject to different requirements in different countries will be captured within a common international framework for the first time. This will not only help banks that operate on an international basis to establish more convergent information bases across the countries in which they are present. It will also facilitate the exchange of information among supervisors, because we will be speaking a more common language. And, more directly, the transparency requirements will, in themselves, lead to the availability of more, and more comparable, data for market participants and users.

Both these initiatives are international in nature. However, as I noted earlier in my intervention, information demands also come from a range of sources including at the domestic level, and it is certainly worth looking to see what can be done at this level too. One such initiative could be to look at the possibility of using IFRS data for market, corporate law, prudential and tax purposes.

2 Convergence of reporting requirements

So, having common regulatory standards and approaches on an international basis can provide a natural basis for more efficient information flows. However, without convergence of the reporting requirements that stem from these standards and approaches, entities will still have to produce and transmit different information, in different formats, to the regulators in the countries in which they are

present. In other words, common regulation does not automatically translate into common reporting requirements - the second element that I want to mention today.

This has been highlighted as a particular issue in the European Union context, given the political objective to promote a fully integrated financial market. Differences in reporting requirements can be seen as a barrier to achieving the full potential of this "single" market, to the extent that they impose an additional cost on those entities operating, or planning to operate, across borders.

Not surprisingly, therefore, there have been a number of calls for regulators to work together to streamline the reporting requirements that apply to institutions which are active on a pan-European basis.

The Committee of European Banking Supervisors, or "CEBS", established two years ago and charged with promoting convergence of supervisory practices and cooperation and information sharing between supervisors, has risen to this challenge and has taken a major initiative in this respect, culminating in the publication of two sets of common reporting templates, one set for institutions to report their solvency ratio results under Basel II, and the other set for institutions to report financial information based on IFRS.

These two projects take advantage of the two initiatives for convergence in international regulatory requirements I have already mentioned. Indeed, it would have been very difficult, if not impossible, to have made progress without them. Both the introduction of International Financial Reporting Standards and the implementation of Basel II are obliging supervisors to modify their existing reporting requirements and systems. This presents a window of opportunity to make progress on more convergent approaches.

The benefits of a common reporting framework are clear, both for the institutions generating the information and for banking supervisors. From the standpoint of financial institutions, administrative costs will decrease, particularly for cross-border banks. At the same time, supervisors will benefit from easier exchange of information. And the framework offers the flexibility to incorporate future modifications with lower costs. Overall, these positive effects should lead to higher quality in the information flows generated.

I should say at this point that neither of these projects has been easy. If you consider that the European Union is currently made up of 25 countries, you can well imagine that the starting situation was complex, with each country requiring its banks to submit different information. In fact, the differences were not limited to the definitions used by each Member State, but also related to the reporting systems, and the technologies and formats used. But I would argue that it has been a very worthwhile initiative, and one that will reap benefits for years to come.

3 Increased reliance on business information

Let me turn now to the third element that I believe is important for success. I believe that regulators should put increased reliance on information generated and used by institutions within their own business. Let me set the context for this remark.

I don't think it is an exaggeration to say that, over recent years, the Basel II initiative has driven a paradigm shift in regulatory attitudes. Regulation used to be something that was rather imposed on institutions "to be complied with", and seen by them as completely separate from their own internal business processes, and therefore an additional cost. But it has been evolving to something which increasingly goes in the direction of recognising and harnessing the best risk management practices of the industry itself, and encouraging institutions to further improve their own risk management practices. As I have already mentioned, Basel II includes explicit economic incentives for institutions to adopt more sophisticated risk measurement and management systems. And to the extent that it is based on institutions' own capital evaluation processes, it brings regulatory capital closer to economic capital.

Such an approach means that regulation becomes less of a separate cost for institutions, which can use the same systems for both business and regulatory purposes. What's more, such regulation can have business benefits, because improved risk management also makes good business sense.

I think the same philosophy is applicable to regulatory reporting. In my view, regulatory reporting requirements should, to the extent possible, be based on internal data used by managers to run their business, and should encourage the effective collection, generation and use of this information for

internal risk management purposes. There is clearly a cost in asking for information that is not used within the business. But more than this, it may well be that internal information is of better quality, more reliable and more accurate than information generated for “external purposes”.

To the extent that Basel II recognises internal risk management systems, the resulting reporting requirements should naturally be based more on the internal information produced by those systems. But I think that over the coming years, we should continue to explore ways to encourage institutions to improve the way they collect and use internal information to run their business and manage their risks, as well as the possibilities for harnessing and using this information as regulators.

4 Increased feed-back to reporting institutions

So far, I have mainly talked about initiatives which regulators can take that should have the impact of reducing the costs of producing financial information. But I think it is possible to go further than this. In fact, I think that we can take initiatives that actually give something back to the reporting entities - in other words, initiatives that provide them with clear benefits. This is the fourth element that I wanted to mention, and perhaps is best explained with a couple of examples.

Let me take my first example from the Spanish context. In Spain, as in some other countries, we maintain a central credit register. This contains information about all the direct and indirect credit exposures – i.e. loans and guarantees – with a value of €6000 or more, which have been granted by banking institutions and other lenders to their clients. As a central bank and banking supervisory authority, we use this database to assist us in evaluating macro-prudential trends and the credit risk in the economy as a whole.

Of course, the data doesn't get into the register of its own accord but rather must be reported by the lending institutions. Reporting this data is complex and costly for the institutions. But they receive useful feedback in return. As contributors to the register, they are entitled to have access to aggregate information on the credit extended by other lenders to potential and actual borrowers. This can be helpful to them in making their own credit decisions and evaluating their credit risk situation.

Let me also mention another international initiative that I think will give something useful back to reporting institutions. This is the initiative to promote increased supervisory transparency, or “supervisory disclosure” as part of the EU implementation of the Basel II framework.

CEBS has developed a framework for supervisory disclosure, with information to be published on CEBS' website, via a set of common templates. While much of the information to be published under the framework relates to supervisory rules and processes, it will also include aggregate national information on the banking sector, on credit risk, operational risk, market risk, and on supervisory actions and measures.

Given that this information will be published in a single location for all EU countries, and in a format that facilitates country-by-country comparisons, institutions will be able to use it to see where they stand in certain key respects against other banks, both on a national and international basis. This will be valuable to them in making evaluations and decisions about their position.

In sum, I think that the general move towards greater transparency by regulators is positive and should be encouraged. But, more than this, we should explore the possibilities to give greater feed-back to reporting institutions, from which they can derive benefits.

5 Taking advantage of new technologies

The final element that I want to mention today is certainly not the least important. I believe that we should make full use of the possibilities offered by new technologies and tools to collect, transmit, manage and analyse the increasing amounts of data we are faced with.

A standard like XBRL can and should play a central role in enhancing information flows. Its great advantage is that it allows for a more precise, reliable and rapid interface between the generators and users of information.

But XBRL is not only a tool for transmission of data. Through the development of “taxonomies” or dictionaries of terms, it allows information to be generated and interpreted on a consistent basis. XBRL

therefore means that financial information from entities can be understood and assimilated in other parts of the world in an accurate and timely manner.

In the banking sector, XBRL could be a means of finding a common language for financial information needs. It could thereby facilitate supervisory co-operation and promote a level playing field.

It is for these reasons that CEBS has decided to promote the use of XBRL in the two common reporting initiatives that I mentioned earlier in my intervention. While national supervisory authorities are free to decide on the technical transmission specifications to implement the new reporting frameworks, CEBS considers that XBRL can be a helpful tool in constructing a harmonised European reporting mechanism, and is therefore developing an XBRL platform which will be available free of charge to national authorities and supervised institutions. XBRL taxonomies are being developed for both frameworks.

Of course, we all recognise that it is not cheap to develop these technologies. But I do believe that the benefits will greatly outweigh the costs in the medium to longer term, and I would encourage every effort to be made to harness those benefits.

Conclusions

Let me finalise my intervention by briefly recapitulating the five elements that I believe are important for progress: First, convergence of the underlying regulation that affects financial institutions and markets. Second, convergence of reporting requirements on the basis of this more harmonised regulation. Third, increased use of internal information, generated for business purposes, for external reporting purposes. Fourth, increased feedback and information to the reporting institutions. And finally, the use of new technologies.

I think the examples I have given from the banking perspective show that we are already making some good progress, although there is of course more that could, and should, be done.

In closing, I would like to thank you for your attention and wish you a productive and enjoyable time here in Madrid.