ICAEW FINANCIAL SERVICES FACULTY

Feedback statement

Feedback statement to ICAEW's discussion paper *Reporting on regulatory capital: choices for assurance*

November 2016

BACKGROUND

In 2014 ICAEW started a project to consider how assurance on banking capital ratios and risk-weighted assets (RWAs) might support confidence in these important measures. In July 2015, we issued a discussion paper which asked a number of questions about the choices involved in seeking and providing assurance on banking capital ratios and related information. We held a number of individual meetings with regulators, investors, analysts, banking executives and banking audit committee chairs. We also held two stakeholder roundtable discussions to explore the issues involved.

OVERALL FINDINGS

The feedback received throughout this process and in the written responses provided a variety of comments about the project. Most responses and stakeholders who we met supported the project to develop an assurance framework on regulatory ratios, recognising that it is important and there is increased interest in this information.

A number of banking institutions wanted to be represented on the working party drafting the guidance. ICAEW expanded the membership of our working party, although notes all members participate as individuals, not representatives of any organisation.

Some respondents were concerned that the development of guidance on assurance might introduce a requirement for banking institutions to receive external assurance on their capital ratios and challenged this on cost-benefit grounds. These concerns were acknowledged within the discussion paper and there remains no intention (or possibility) of any such requirement being introduced by ICAEW. Most who raised this concern recognised that it would be useful, nonetheless, to have an assurance framework if it did not contain a prescriptive scope, was flexible, and could be used by internal auditors as well as external assurance providers. The framework that has been developed is designed to be used voluntarily by internal or external assurance providers.

Many written responses from banking institutions, and some from external assurance providers, questioned the demand for mandatory external assurance on capital ratios. Some felt that assurance might not address the difficult question of comparability between the capital ratios of different banking institutions. It was also noted that the cost of the end-to-end assurance on published capital ratios envisioned in our discussion paper may be prohibitive for many institutions. This was due to the complexity of the subject matter and the breadth of information and systems involved, as well as the low number of investor requests for this assurance. Again, a voluntary framework can allow the provision of assurance to grow with demand, and the modular framework assist those with a specific area of interest or concern.

Many respondents suggested that it would be unlikely that a one-size-fits all approach to assurance could meet the needs of everyone. For example, large and small institutions may have different needs and priorities when seeking assurance, and some

> This feedback statement accompanies an exposure draft of guidance *Banking regulatory ratios: ICAEW assurance framework* [icaew.com/assuranceframework]. It sets out the reasons for the decisions taken by ICAEW on the questions asked in our discussion paper, along with a summary of the feedback we received in our stakeholder meetings and discussion paper responses. The exposure draft of guidance is open for public consultation for a three month period until 13 February 2017. In addition to receiving written responses, we are also undertaking an outreach programme to meet with stakeholders and interested parties for them to share their views on the guidance. If you would like to take part in this outreach, we welcome formal and informal input. Instructions on how to get in touch can be found within the exposure draft document.

institutions may wish to obtain assurance on only part of their regulatory calculations, processes or controls at one time.

We have sought to address these concerns in particular through the development of a modular framework which allows those seeking assurance to target particular risks or areas depending upon their area of focus.

Much of the feedback noted that, especially in the initial years, institutions are more like to seek assurance from their internal audit teams than from an external provider. As such, many banking institutions recognised that having a framework for such assurance would be useful if it allowed them the flexibility to voluntarily commission this either from their own internal audit teams or from external providers. It is intended that the flexible approach proposed will easily facilitate adoption within a phased or rotational approach by internal auditors, as well as allowing an end-to-end assurance engagement from an independent assurance provider, if desired.

We have received encouragement to continue this project from a number of banking regulators in different jurisdictions. We are also aware that a number of banks have privately commissioned assurance reports on elements of their capital ratios, models or risk-weighted asset calculations.

The exposure draft has been written with reference to international standards where applicable and presents a principles based approach accompanied by illustrative examples. It is neutral to jurisdiction of use and does not generally reference any particular regulatory regime.

RESPONSES TO QUESTIONS RAISED IN DISCUSSION PAPER

Q1: Do you agree with our proposed approach to developing guidance?

The discussion paper explored developing a standard scope for assurance. The feedback said guidance should not be prescriptive and should not specify a single way of providing or approaching the provision of assurance.

Our exposure draft has been developed on the basis of presenting a flexible, modular approach to assurance which can be used by a variety of assurance providers, both internal and external, to cover a variety of subject matter elements of regulatory ratios depending upon the needs of the particular business.

Q2: Which users should an assurance report be designed for and what form of reporting would be most appropriate?

Respondents noted that assurance reports may be of benefit to a variety of users. However, many respondents emphasised that different recipients would have different needs from reporting.

As this guidance is for internal and external assurance providers, the draft guidance around reporting focuses on the need to present information in a clear and meaningful way. The best way for the assurance provider to present their findings may vary depending upon the type of work and who is receiving the report. As demand for assurance evolves, different types of reporting may be developed. User demand will influence the type of reporting which is appropriate in this area. Therefore the exposure draft does not propose a particular form of reporting to be adopted, nor are example reports provided.

Q3: What do you consider to be the most useful subject matter for assurance and why:

- **risk-weighted assets;**
- **the CET1 ratio; or**
- **other regulatory measures or relevant disclosures?**

There were a variety of views amongst respondents. Some respondents felt that the guidance should specifically focus on RWAs, whereas others felt it should be applicable to regulatory measures more widely, given the increasing focus on other measures, such as leverage, and liquidity ratios.

Given the potential variety of subject matter which could be assured, the approach within the exposure draft is intended to provide a flexible, principles-based approach that can be applied to different regulatory ratios. The title of the exposure draft refers to regulatory ratios rather than regulatory capital to reflect this. To make the guidance more practical and meaningful, the exposure draft includes examples to describe certain points. These examples refer to RWAs for illustrative purposes as we believe this guidance may be initially used on those. However, the examples could equally have referred to other regulatory measures and should be more broadly applicable.

Q4: Do you think that assurance should be provided on the controls during the period, the periodic capital ratio calculations or both? Which type of assurance would you consider to be of greatest value, and why?

For many institutions controls over regulatory measures are being strengthened in-line with regulatory expectation and increasing management prioritisation of the calculations. Most respondents agreed that the approach to controls should be adaptable to enable assurance as controls within regulatory reporting become more developed and use of disclosure becomes more sophisticated.

The exposure draft considers assurance on controls as well as substantive work on a particular calculation. Different banking institutions will potentially gain different benefits from different types of assurance depending upon the nature of their calculations and sophistication of their processes. The type of assurance to be provided, therefore, should be carefully considered and discussed between the institution and the assurance provider and agreed.

Q5: What should be the role of the assurance provider regarding model design, adherence to the capital rules, and regulatory approvals?

A number of respondents expressed concern that there may be confusion or potentially unhelpful overlap with the role of the regulator were model design to be considered by assurance providers. Under the Basel rules regulators are responsible for approving model design. The discussion paper acknowledged that the value of assurance work may be in reporting on adherence to approved models and the governance processes which surround those models rather than providing an opinion on whether the model design complies with the underlying rules.

Given that the exposure draft does not seek to set out any standard scope for assurance, it does not explicitly address the assurance provider's responsibilities for reporting on model design or adherence to the capital rules. This will depend upon the scope of the individual engagement and the nature of the assurance provider. For example, an internal auditor may have a role in reviewing models prior to their submission to the regulator.

Nonetheless, given the regulator's role in approving any use of internal models, ICAEW recognises that, while there will be a range of useful work which can be performed in relation to banks using an internal ratings based (IRB) approach, opining on matters which may conflict with the regulator's remit, for example compliance with underlying regulation may be of limited value and may create a conflict of interest.

Q6: Taking account of costs and benefits, should assurance be provided on an end-to-end basis, including obtaining evidence to support input data, or should it be based only on proper extraction from underlying systems?

Most banking institution respondents felt that end-to-end assurance may be cost prohibitive for many potential users of assurance, so should not be the prescribed approach in the guidance, but did acknowledge that it should be possible.

Listening to this feedback, and the desire for flexibility to target specific areas, we have developed the modular framework using a matrix structure to help those seeking assurance. This would not preclude end-to-end assurance as an option, but it is acknowledged there may be additional challenges associated with this type of work in the first instance.

Q7: Would you prefer an approach which led to reasonable assurance, limited assurance or the completion of agreed-upon-procedures, and would your preference be different for interim and year-end information?

Most respondents, at least initially, wanted assurance to be performed by internal audit. Reasonable assurance, limited assurance or agreed upon procedures were therefore less relevant to their consideration. However there was support for guidance which allowed a variety of options as to the type of reporting produced.

As noted in our answer to question 2, it will be important for parties to agree the type of conclusion and report to be delivered. The exposure draft does not present a preferred approach, and principles for high quality reporting are discussed within the reporting section.

Q8: To what extent should guidance cover the areas noted or other matters?

There was generally a desire for assurance to be aligned to how banking institutions produce their regulatory information, so that stakeholders could understand the relevance of assurance for a particular disclosure or ratio.

This has informed the way in which the modular framework has been developed. The way it has been integrated into the exposure draft allows us to add further sections as needed.

Q9: Are there any particular matters we should consider around the comparability of information in developing a scope for assurance? Do you think that more disclosure would need to be given in order to provide a reasonable assurance opinion? If so, what additional information would be required?

Our discussion paper explained that the capital rules that allow banks to use their internal models mean that different banks capital ratios are not directly comparable. It also explained that, while assurance might provide more confidence that an institutions was applying the rules consistently from one period to the next, it would not on its own solve the problem of lack of comparability. Additional disclosures, or more prescriptive rules, would be needed for this. Assurance could then provide users with greater confidence that the institutions was properly following the models or processes described.

Some responses from banking institutions stressed that comparability between institutions is one of the most important issues around their disclosures on regulatory information. Since assurance does not address this issue, they questioned the value of public assurance on capital ratios. They argued instead for more or better disclosures to facilitate greater comparability. They also noted that other indicators, such as RWA density, can provide useful information for their stakeholders.

ICAEW does not agree that lack of comparability is an argument against public assurance. However, for assurance to be meaningful, readers must be able to understand the basis of preparation against which assurance is being provided. Therefore, providing sufficient information to allow comparison between banks may be a necessary precondition for public assurance on regulatory information. This may be less of an issue for internal users or regulators who have access to the full details of the internal models, control processes and other information.

Our discussion paper sought views on what additional disclosures would be needed to allow external users to understand what assurance was being provided against. Other than highlighting that current disclosures may be inadequate, we did not receive feedback on what level or type of disclosure would be needed for public assurance.

It is for bodies such as the Basel Committee on Banking Supervision, the Enhanced Disclosures Task Force and potentially the International Accounting Standards Board to consider which disclosures would improve comparability. The exposure draft does not suggest disclosures necessary to support an assurance report. This may depend upon the intended users of the report. It instead suggests that assurance providers in their reporting make clear to users what assurance is being provided against.

Q10: How should assurance providers address the proximity to minimum capital requirements or other triggers in considering materiality? Should assurance reports disclose information about materiality considerations?

Respondents agreed that the proximity of a banking institution to its capital requirements is important and should be considered in designing a work programme and determining the amount of evidence which will be needed.

The reporting section of the exposure draft considers the disclosure of materiality considerations and their role in creating valuable reporting which is more informative to users.

Q11: Do you think assurance on capital information should be provided regularly or on an ad hoc basis? If regular assurance is to be provided, should the frequency of assurance be aligned with financial reporting audit and review requirements?

There were a variety of views from respondents. Ultimately, a regular programme of assurance may produce greater value and improvements than a one off or ad-hoc engagement, but might be too large a project to take on at the current time. A rotational basis or phased approach, facilitated by the modular framework, could be desirable.

Given that the exposure draft sets out a flexible, modular framework for assurance, it does not prescribe the frequency of reporting.

Q12: Do you have any views on the factors that might affect the costs and benefits of an assurance report on capital information?

All written responses noted that the cost of such assurance from external providers should not be underestimated. This drove much of the desire for flexibility within the guidance so as to be able to spread the cost of work (whether performed internally or externally) and target priority areas so as to address risks in a sensible manner. Many respondents felt that the option to have work performed by internal audit could significantly reduce the costs.

Some respondents to the discussion paper felt that ICAEW should undertake a cost benefit analysis in advance of producing guidance. We have not undertaken a cost-benefit analysis because we are proposing a voluntary framework to be used where benefits justify the costs involved.

Individual institutions, however, should undertake a cost-benefit analysis when considering whether to commission assurance and what form that assurance will take. Among the factors which will affect the costs and benefits of assurance are the scope of assurance, the subject matter, whether it is provided on an end-to-end basis or on a particular component of a process, whether it will be reported privately to the directors or publicly, whether it is provided by internal or external assurance providers and the type of assurance report provided.

Q13: Should the provision of assurance on capital information be included as a permitted non-audit service?

It was generally recognised that there would be some potential constraints to performance of this work due to independence requirements for statutory auditors, including fee caps for performance of non-audit work as set out in the EU regulation and the in the UK in the Financial Reporting Council's Revised Ethical Standard 2016. However, should external assurance be sought, it was agreed it would be sensible for the external auditor to be allowed to provide it since the nature and objectives of this work is broadly similar to that of an audit.

The exposure draft refers assurance providers to their own professional guidance, including ICAEW's code of ethics, to consider any independence requirements. ICAEW does not have the authority to set out what is a permitted non-audit service for public interest entities. However, should independence restrictions become a constraint on the provision of services, ICAEW will make representations based upon the feedback we received in response to our discussion paper.

Q14: Do you have any views on transitional arrangements or on other areas that require further consideration?

Given the variety of views received around what assurance may be useful and what a framework could look like, we did not receive feedback on transitional requirements other than that assurance would be unlikely to be made public for a number of years. We believe it may have been early to ask this question.

The approach within the exposure draft is flexible so that it could be used on a transitional basis with private, modular reporting. As with any previously unaudited areas there will likely be a learning curve which enables a greater level of reporting as progress is made by banking institutions.

OTHER COMMENTS

The following additional points were also raised during the feedback process which do not directly relate to questions in the discussion paper.

Skills and expertise

A few respondents expressed concern that the skills and expertise of external assurance providers may need to grow, and additional specialist resource may be required, which could present challenges.

The exposure draft acknowledges that this is a difficult subject area, and that any assurance provider must possess the requisite experience and expertise before performing assurance work in this area. We understand from our discussions during the feedback process that there is an increasing amount of assurance work being performed on regulatory information, by both internal and external assurance providers. This will result in a natural increase in skills and experience over time across the industry. While it might require short term investment in training, this should not be a barrier to the provision of these important services.

The Financial Services Faculty was established to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from ICAEW members specialising in the sector and provides a range of information and services.

The *Inspiring Confidence in Financial Services* aims to provoke new thinking and identify better ways of tackling long-term challenges in the financial services sector. Confidence is vital to financial services. A stable financial system is important to the economy and sustainable levels of confidence in financial services are needed for this stability.

Our work is based upon four themes, which are interdependent and cannot be considered in isolation. These themes are:

- responsible providers;
- responsible consumers;
- better information; and
- better regulation.

Our work involves developing reports and provocative issues papers, holding high-profile conferences and having discussions with stakeholders. We aim to bring together the financial services sector, industry professionals, consumers, regulators and policymakers. We believe that financial services will only inspire confidence if the sector engages with all of its stakeholders.

For more information about the Inspiring Confidence in Financial Services initiative, visit icaew.com/inspiringconfidence. For more information about the Financial Services Faculty visit icaew.com/fsf.

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