

# Do more disclosures enhance transparency in the financial industry?

For years now, financial intermediaries and banks in particular have been exposed to a constant increase in the intensity of regulation. Regulation projects in this area concern accounting as well as supervisory aspects, at both national and international levels. What all regulation projects have in common is that they constantly require banks to disclose more information which is to some extent identical or similar. This raises the question of whether more information results in improved transparency.



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□ However, a look into the past shows that disclosure and transparency should be viewed differently. Too much information can sometimes make it more difficult to analyze financial results, culminating in speculations which may produce undesirable price volatility. Good Corporate Governance would nowadays be unimaginable without an information policy of high quality. Quality, not quantity, is called for. The requirement for *risk-oriented, transparent* disclosure cannot be ignored.

**Qualitative requirements for transparent disclosure**  
Recipients of information have different disclosure requirements. Whereas the interest of supervisory authorities focuses on the protection of creditors, investors and image (system stability and protection of reputation or trust), investors require information that allows them to assess

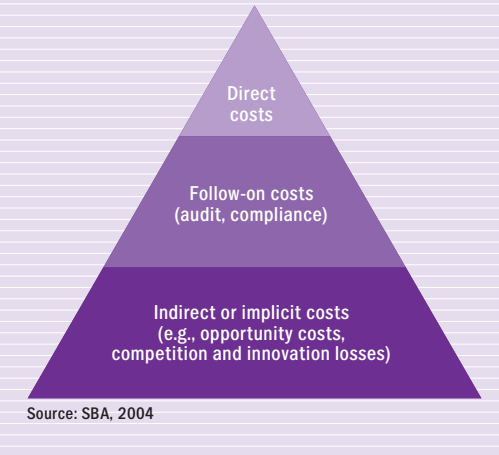
their investments in terms of performance. Regardless of the different stakeholders, transparency means the disclosure of reliable and up-to-date information about financial results, the financial situation (equity capital, liquidity), the strategy and practice of risk management, risks entered into, accounting policies and Corporate Governance. The following generally recognized principles will help to achieve disclosure of high quality which is therefore transparent:

- completeness
- relevance and up-to-date content
- reliability
- comparability
- materiality

#### Regulatory burden: cost/benefit considerations

As far as banks are concerned, the major challenge in dealing with disclosure projects nowadays is to bring about the provision of a variety of information in a cost-effective manner. For this purpose, it is necessary to carry out analyses of the regulatory benefit as well as the costs of regulation. Measurements and information relating to the benefit are, however, not yet available in most cases at present. On the costs side, a distinction can be made between direct costs, subsequent costs and implicit costs. The direct costs of regulation include supervisory dues and fees. The subsequent costs include the costs of internal and external auditing, as well as compliance costs. The latter involve all costs relating to the adherence to regulatory provisions, including further training and the development and maintenance of IT systems in the controlling and reporting sector. Implicit costs relate to opportunity costs for lost earnings. As of today, there are only a few empirical studies of this regulatory burden in Switzerland (regulatory cost-to-benefit analyses). On the basis of initial analyses, it can nevertheless be assumed that the subsequent costs and the implicit costs together account for the largest share.

#### Costs for disclosure projects



#### Requirement for risk-oriented regulation

The calls (which have recently become loud) for a differentiated, risk-oriented approach to regulation should therefore be considered against this background of costs, which impose a relatively greater burden on smaller institutions than on their large competitors. The (scarce) resources must be used wherever the risks are rated as especially high.

At all events, the “one-size-fits-all” principle, which is widely established in existing practice, together with a strict “zero tolerance” policy no longer appear to be adequate given the heterogeneous nature of financial intermediaries. What is therefore needed is a differentiated approach based on materiality and risk characteristics. Information is deemed to be material if its absence, or false representation, could negatively influence the judgment or decision by the relevant recipients. Is a trend toward risk-oriented regulation already perceived in practice?

#### Examples from current practice with a risk-oriented approach

It is pleasing to see from the analysis of 

several recent regulation projects that a development toward a risk-oriented approach is evident.

The Swiss Federal Banking Commission (SFBC) is bringing the new *circular on "Supervision and Internal Monitoring"* into force on January 1, 2007. This circular aims to strengthen Corporate Governance among Swiss banks, securities traders, financial groups and financial conglomerates. It regulates the independence of the board of directors, the establishment of an audit committee, the duties of the internal auditors and the responsibilities of the compliance function and risk monitoring. Numerous points of concern for the banking sector were ultimately incorporated into the new circular during the course of an intensive consultation process. In particular, it should be emphasized that financial intermediaries can differentiate the implementation of the new regulations in consideration of their *size* and the *complexity* of their *activities*, enabling implementation on an institution-specific basis according to risk-oriented aspects. By applying the so-called *comply-or-explain clause*, the players can also be very flexible in their approach to certain provisions (e.g. they may opt not to set up an audit committee even though one or more criteria are applicable).

The *Basel II Disclosure Standards (Pillar 3)* allow market forces to have a regulatory effect. This principle presupposes that well-informed market participants prefer risk-conscious corporate management with effective risk management, whereas risky business conduct is punished by sanctions. However, a mechanism of this sort can only produce its effect if transparent information is available to the market participants. In its circular on "Disclosure of Capital Adequacy," the SFBC regulates the extent to which market players are obliged to disclose information on capital resources and on credit, market and operational risks. The disclosure concept is flexible in nature, and it includes qualitative as well as quantitative

information. Qualitative information must be compiled or adapted in consideration of the *activities undertaken* and their *materiality*. Quantitative information is specified in terms of content, but may be provided in consideration of the *nature* and *materiality* of the *business activities*. The effective date is January 1, 2007.

August 2005 saw the publication by the IASB of standard IFRS 7, "Financial Instruments: Disclosures," placing the disclosures on financial instruments in the center of attention. The new disclosure regulations should allow readers of financial statements to better assess the following aspects:

- the importance of financial instruments for the company's financial situation and earning power;
- the nature and extent of risks arising from financial instruments to which the company is exposed during the reporting period and on the reporting date, and the manner in which these risks are managed (market, credit and liquidity risk).

The standard leaves it for the companies to decide how detailed the information on compliance with the disclosure requirements should be, taking into consideration their *individual circumstances* (management approach). The principle of *materiality* stipulated in IAS 1 is also applicable in relation to IFRS 7. IFRS users must implement IFRS 7 for the first time as of January 1, 2007.

#### Utilizing the synergies of disclosure projects

The three examples explained above clearly illustrate that the financial market players are granted leeway for transparent disclosure based on materiality characteristics by the various standard-setters (SFBC, Basel Committee, IASB). However, this should not obscure the fact that the financial intermediaries have to come to terms with very complex questions, duplicated content, cost-



intensive IT projects and overlapping introduction dates. One particular challenge is to identify synergy potential resulting from the convergence of several disclosure projects (e.g. Basel II [Pillar 3] with IFRS 7) at an early stage. For example, the methods that are used internally could also be utilized for external reporting purposes. In order to implement this goal, there is a need for an integrated approach with intercoordinated reporting and IT processes (cf. Figure 2, Checklist). The benefits of an integrated approach may be summarized as follows:

- improved transparency and therefore added value for the recipients
- optimized internal procedures and processes
- reduced compliance costs
- analysis and review of existing IT solutions
- strengthened internal monitoring system

**Regulation is becoming increasingly international in nature**

Although overregulation is damaging in economic terms, gaps in supervision are equally undesirable. Transparent disclosure is risk-oriented and is based on principles; it takes account of materiality characteristics and as a result it creates benefits – specifically trust.

Despite recent achievements such as the “comply-or-explain” clause or the rejection of the “one-size-fits-all” principle, we should not forget that regulation projects are not restricted by national frontiers. With the implementation of the Markets in Financial Instruments Directive (MiFID), the European financial market is faced with far-reaching changes regarding securities transactions. Financial players, supervisory authorities and policy-making circles are confronting with major challenges which require risk-oriented solutions. However, these should be assessed not only from the viewpoint of compliance but also in terms of increased performance.

**Checklist for an integrated approach**

- How should the project organization be set up?
- Are all the major know-how carriers appropriately integrated into the projects?
- What objective does the implementation aim to achieve?
  - attainment of best practice?
  - attainment of good practice?
  - attainment of minimum standard?
- Is a common regulation of the language (terminology) ensured?
- Should the organizational structure be reconsidered?
- Which IT systems are affected?
- Which dependencies and interfaces can be identified?
- Which business and support processes are affected?
- Which capital variables should be taken into account (regulatory, balance sheet or economic capital)?
- Which risk measures should be used?