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UK BANK RISK DISCLOSURES IN THE PERIOD THROUGH TO THE ONSET OF THE GLOBAL FINANCIAL CRISIS

BRIEFING

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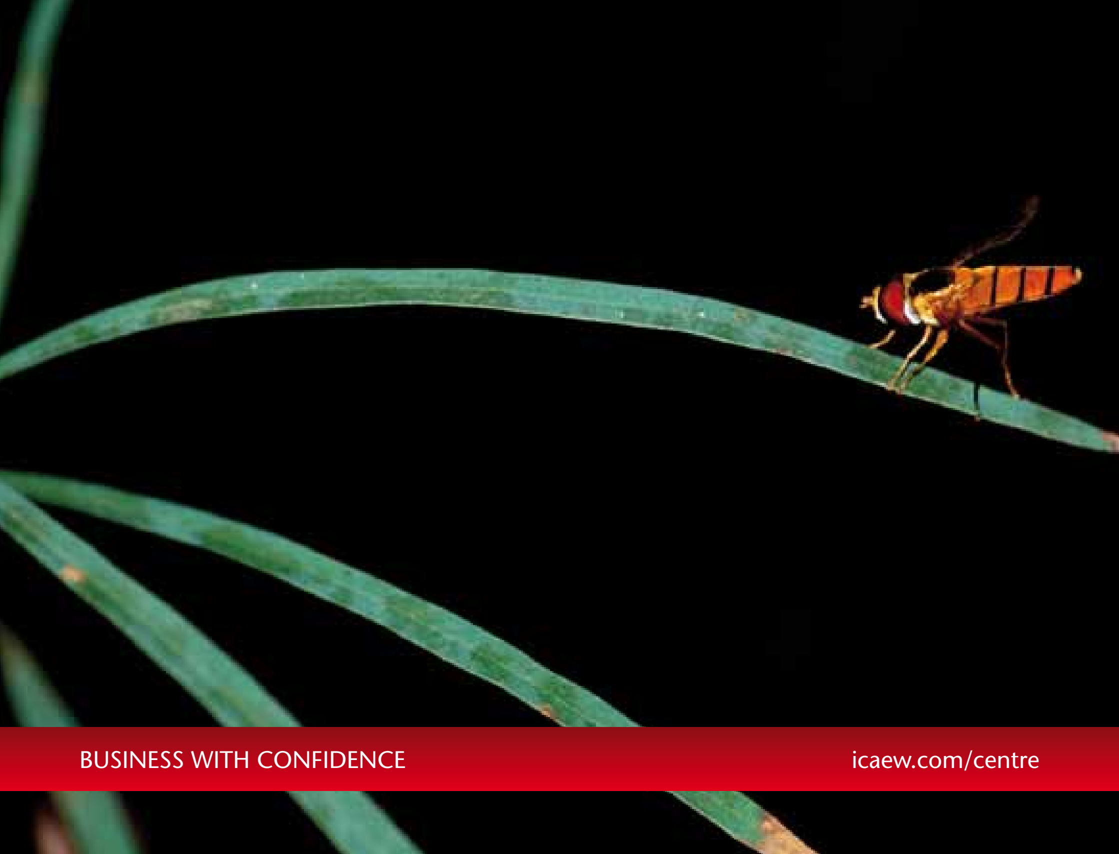

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SUMMARY

It has been acknowledged for some years that companies should be providing relevant risk and risk management information within their annual reports. The need for risk reporting arises as uncertainties are an inherent feature of business, and investors and other interested parties can only assess the current and future risk position of a company if appropriate risk information is disclosed. Following the credit crisis, the issue of risk disclosure within the annual reports of banks has gained even greater prominence. This has resulted in calls for more coherent and lucid risk reports to be developed to enable the reader to better understand the risks that banks are facing.

This briefing reports on the findings of a study of UK bank risk disclosures in the period through to the onset of the credit crisis. The scope of the study is confined to examining the narrative reporting of risk within the annual reports for eight major UK banks over a period of seven years.

The findings confirm that a risk narrative is identifiable for each of the sample banks, but that it is hidden. Consequently, substantial effort is required to piece together the overall risk narrative. There is no evidence that there is deliberate intent on the part of the banks to make the risk narrative inaccessible.

The briefing concludes that a coherent risk narrative should be provided by banks that reflects the specific risk dialogues that have been occurring within each bank over time. Pillar 3 of Basel II requires banks to disclose specific and highly detailed risk information. However, if attention is focused solely upon these Pillar 3 disclosures then we neglect to remember that risk is fundamentally concerned with unknowable future events.

Key implications that then arise are:

1. a risk narrative can never be perfect – risk is too complex an issue to permit this;
2. the form of the risk narrative cannot be prescribed – the shape of the narrative will be influenced by the individual bank's risk dialogues and it is preferable that banks experiment with alternative risk narratives; and
3. the crafting of the narrative should be deemed a part of the risk management process – preparation of the risk narrative presents a significant opportunity for managers to reflect upon and question the perception of risk that permeates the bank.

1. BACKGROUND

ICAEW's *Information for Better Markets and Inspiring Confidence in Financial Services* initiatives have both recognised the fundamental importance of information flows in creating and maintaining effective markets. The annual report is a primary source of information for investors and other stakeholders. For directors to discharge their reporting duties, the 2010 UK Corporate Governance Code states as a main principle of accountability that 'the board should present a balanced and understandable assessment of the company's position and prospects'.[1] If the reader of the annual report is to be able to assess the position and prospects of a company then it is essential for risk information to be disclosed. Notwithstanding that it is now a requirement that the business review contain a description of principal risks and uncertainties,[2] the quality and utility of current risk disclosures has been subject to criticism (see for example, ASB, 2009).

The risk information provided by banks has come under particular scrutiny in the wake of the credit crisis. The ICAEW report *Audit of Banks: Lessons from the Crisis* (2010) expresses the need for better presentation of risk information that clearly presents a complete risk picture for the bank and the Walker review of corporate governance in UK banks (2009) proposes the preparation of a risk report by banks 'to assist shareholders through improving their understanding of the governance of risk-taking and of the risk appetite and performance of their investee company' (p104).

Allied to this a number of recent discussion papers have focused upon the twin issues of how to reduce the complexity of corporate reports while also improving their usefulness for the reader (see for example, FRC, 2009; GAA, 2008, IFAC, 2008). This is particularly relevant in relation to bank risk reporting as the nature of the risks that a bank faces can be harder to comprehend than those of a non-financial firm and the very detailed risk disclosures required under Pillar 3 of Basel II difficult to evaluate. Therefore, narrative risk information provided within a bank's annual report needs to be of high quality as it is an opportunity to present a coherent risk account to the reader.

1 Section C.1: Financial and Business Reporting.

2 Companies Act 2006 s417.

2. RESEARCH APPROACH

The study examined narrative risk disclosures in the annual reports of the following eight banks:

- Alliance & Leicester;
- Barclays;
- Bradford & Bingley;
- HBOS;
- HSBC;
- LloydsTSB;
- Northern Rock; and
- Royal Bank of Scotland.

The annual reports selected for each bank covered the seven-year period from 2002 to 2008.

The risk disclosures were those identified within the narrative sections of the annual reports and these disclosures were then analysed to identify themes and sub-themes in order to establish whether a consistent risk 'story' or narrative could be identified for each bank. In addition the tone of the risk disclosures was analysed to ascertain if this aided in understanding how the risk 'story' was being told. Diction software was used to analyse three aspects of tone: optimism, certainty and activity.

The selection of a seven-year sample period facilitated an assessment of whether the risk narrative remained static or evolved over time. Additionally, the analysis was performed to facilitate some assessment of the quality of the risk disclosures and, hence, to suggest how risk reporting by banks may be improved.

To identify the risk disclosures, the entire narrative section of each annual report was scrutinised and a set of decision rules then applied to determine which parts of the narrative sections should be classified as risk disclosures. This set of decision rules relied upon a broad definition of risk that encompassed all potential risk categories (including market risk, credit risk, interest rate risk, operational risk, reputational risk and sustainability risk), and incorporated upside as well as downside risks and uncertainties. It should be acknowledged that employing a different definition of risk may result in a different selection of risk disclosures.

The research also examined press releases issued by the banks to ascertain if this provided corroboration for the risk story identified within the narrative risk disclosures.

The research did not review other reports published by the banks, such as sustainability reports or corporate responsibility reports which can contain risk-related information.

3. FINDINGS

A consistent risk narrative for each of the sample banks has been identified up to the onset of the crisis. These risk narratives evolve throughout the 2002–2006 annual report risk disclosures and remain intact in the 2007 annual report risk disclosures (as the crisis starts to emerge), with all bar one of the banks indicating that their risk management approach should ensure that they are robust enough to contend with the risks envisaged for 2008. The risk narratives of the banks prior to the onset of the crisis do not suggest major problems are imminent. The 2008 annual report risk disclosures alter dramatically as the banks review their risk positions and the risk environment in the wake of the crisis and, therefore, a fundamentally different risk narrative appears that is largely dependent upon how severely the bank has been affected by the crisis. This briefing focuses upon providing a summary of the risk disclosures prior to 2008.

3.1 The banks' risk narratives 2002–2007

In all cases prior to the crisis the narratives portray the banks as having a sound awareness of the risk environment and a propensity to adapt their risk management approaches as the risk environment changes. They display a confidence in their ability to manage the risks they are confronted with and there is no forewarning that a crisis may be imminent within these narratives.

The analysis of the tone of the risk narratives indicates that there is an increasing optimism as the pre-crisis period progresses. This potentially influences readers to adopt a relatively more accepting and unquestioning stance towards the risk view of the banks as they (unconsciously) absorb this optimism. However, given the complex nature of risk, it would be more appropriate for readers to adopt a proactive and questioning attitude towards the risk view of the banks. The mood of optimism noted in respect of the pre-crisis risk disclosures dissipates post-crisis. The certainty aspect of their tone, which is associated with ideas of resolve and perseverance, tends to decrease over the pre-crisis period and then increases post-crisis. A similar pattern, albeit to a lesser extent, is noted in respect of the activity aspect of their tone. The decrease in certainty and activity tones pre-crisis are likely to be connected with the increased mood of optimism, for if there is a belief that 'all is well' then managers feel less pressure to convey determination to undertake decisive actions. Conversely, the banks' managers adopting an attitude of certainty and activity post-crisis can serve to reassure readers that they are acting determinedly to manage the risks associated with the crisis.

Risk narratives for four of the sample banks for the period 2002–2007 are summarised below. The press releases examined contained minimal risk information and, therefore, they neither corroborate nor contradict the identified risk narratives.

Bank A – Risk narrative: risk management and diversification

Risk management is a strategic priority within the bank, considered essential for delivering value for the business. Alongside discussions of accepted bank risks (for example, credit risk and market risk) it is noted how the significant amounts of regulatory change, bank industry consultations, and compliance and governance initiatives are a further source of uncertainty. Overall there is a disciplined approach to risk management, including lending and the management of capital. Strong risk controls are enacted, and risks continually reviewed with actions being taken when conditions change (for example, tightening retail lending criteria as conditions in relevant sectors deteriorate). A risk appetite framework operates with rebalancing of the business portfolio occurring if forecasted risk levels exceed the bank's risk appetite. Diversification (across products, customer sectors and geography) is considered key in providing a defence against the impacts of difficult environments. Exposures to the sub-prime market were reduced at the outset of 2007 and liquidity risk proactively managed. Overall, this risk management approach is adjudged to have aided the bank in being able to handle the difficult market conditions of 2007.

Summary

- **Risk management priority**
- **Disciplined approach to risk management**
- **Risk appetite framework**
- **Risk reduction through diversification**

Bank B – Risk narrative: a bank that can manage the risk-return relationship

The outcome of a cautious risk-reward approach is that the bank is selective regarding which markets it operates in; it does not write unsecured personal loans and disposes of non-core businesses where there is high gearing and high earnings volatility. The risk-reward approach has created a simpler, stronger business which balances novel product design with prudent risk management. The markets selected by the bank to operate in are the more profitable mortgage market sectors (buy to let, self-certification and lifetime); here the bank has the expertise necessary to create and distribute these mortgage loans. Hence, it can build competitive advantage whilst still safeguarding risk levels through high lending standards and low levels of arrears. Specifically, risk associated with lending is managed using sophisticated approaches to credit scoring, being cautious in underwriting and being proactive in detecting fraud. Wider risk management principles are also in place: strong equity cover, diversified lending, high levels of liquid assets and alternative funding sources. Therefore, whilst the bank looks to be in markets that are more complex, it is controlling the risk. This sense of control carries through to 2007 as a conservative approach to business has given it a solid foundation, and it has the expertise and strategies to endure the difficulties the banking sector is experiencing.

Summary

- **Prudent**
- **Selective in which markets it operates**
- **In control of risk management**
- **Expertise**

Bank C – Risk narrative: a bank that makes risk-based decisions

The bank considers the way to increase profit without increasing risk is:

- stick to operating in those sectors you know best;
- have a strategy of offering products that have value and are uncomplicated as this will attract good-quality lower-risk customers; and
- be willing to turn aside business if it compromises credit quality. If market conditions are difficult then be realistic, while also being prepared to swim against the tide as difficult conditions can still provide opportunities.

Banks cannot be completely immune to credit risk, but a commitment to identifying, understanding and managing risk, and having a proactive, professional and adjustable approach to credit risk assessment ensures credit quality remains strong. This way an appropriate return is generated for the risk being taken on and if market conditions deteriorate lending criteria can be tightened. This conservative approach to risk aids the board in creating financial stability and results in strong credit quality. Therefore, even when the difficulties arise in the financial sector in 2007 the bank foresees it will be able to take advantage of opportunities that will inevitably arise in the uncertain times ahead, whilst remaining disciplined in its strategic approach to new prospects and appraising the risk of opportunities. Adjustments to the liquidity risk profile that have been made, in conjunction with diversifying funding in recent years, should ensure that decisions on opportunities will not be hampered by liquidity difficulties.

Summary

- **Stick to what you know**
- **There is no immunity from risk but it can be managed**
- **Do not compromise on credit quality to grow quickly**
- **Maintain discipline when appraising opportunities in difficult periods**

Bank D – Risk narrative: focusing on the upside of risk

Opportunity (the upside of risk) is the focal point albeit with reference to the management of (downside) risk. Thus, the bank is concerned to create shareholder value through growing income, whilst also focusing on credit quality. Commonly, provisions for impairments are stated to have increased because of growth in lending, but overall credit quality remains good. Notwithstanding the risks that arise because of the intense competition faced in all markets, a diverse range of opportunities gives the bank the confidence that it will be successful in the future. Growth can be achieved by entering new markets; however the intent is to steer away from activities or geographic markets that are unduly volatile. Ensuring capital is put to most favourable use for shareholders is also fundamental, but a prudent approach is adopted to ensure the capital base is sound and appropriate given the underlying risks of the bank. In 2007 the business model is still considered fundamentally robust and the good financial results are considered due to diversification of income streams and a focus on risk management and credit quality. Potential exposure to credit risk is discussed with the causes identified as high US mortgage delinquency rates and downward pressure on house prices, but looking ahead to 2008 there remains a confidence that sound growth opportunities will still be available despite the difficult conditions of the second half of 2007.

Summary

- **Growth focus, but managing risk**
- **Lending increasing, but credit quality sound**
- **Entering new markets, but avoiding overly volatile opportunities**
- **Robust business model with diversification of income streams**

Significant comments regarding the risk narratives are set out below.

3.2 Inaccessibility of the risk narrative

Commonly, risk disclosure studies conclude that high quality corporate risk reporting will result if banks (and, equally, non-financial institutions) can be persuaded to locate all risk information in one place in the annual report, to be open in their risk discussions and to provide relevant contextual background. Therefore, it is positive that a coherent risk narrative can be identified for the banks in question. It is also positive that the narratives are not always confined to specific banking-related risks (for example, market risk and credit risk) and that broader business risks (for example, reputation risk and environmental risk) will form a part of the narratives for some banks.

However, the risk- and risk management-related information that formed the basis of the risk narratives identified in the study is widely dispersed throughout the annual report. Therefore, the identification of a risk narrative for each bank is only possible if a reader is prepared to spend considerable time searching for relevant risk disclosures and then analysing key risk themes. Further, it would be difficult to identify the risk narrative if an annual report is read in isolation as the risk narratives only become discernible when a sequence of annual reports are examined covering a period of some years. The presentation of key risk factors that is present in many annual reports tends to be a rehearsal of generalised risks that face the overall banking sector and this does not aid in understanding the risk narrative of the individual bank. Therefore, the risk narrative is inaccessible and this is problematic.

3.3 Is the inaccessibility of the risk narrative intentional?

There is no evidence to suggest that it is an intentional strategy on the part of the banks to obscure the risk narrative. The themes that comprise the risk narratives often recur in different sections of the annual report and this reinforces the sense that, although difficult to uncover, there is a coherent risk narrative being presented in the annual reports.

The language used in the risk disclosures is not overly technical and the vocabulary is predominantly free of jargon. Therefore, sophisticated banking expertise is not required to comprehend the narrative risk disclosures.

Although the risk disclosures have a particular rhetorical tone (as explained above) it is not apparent that there is any deliberate intent on the part of the banks to manipulate the reader to interpret the narrative in a particular manner. The optimistic tone present pre-crisis is just as likely to be a reflection of a wider societal confidence that was present in that period. Post-crisis there appears an openness in the annual reports to discuss the crisis, the wider issue of systemic risk and the specific risks relevant to the individual bank. The risk discussions post-crisis differ markedly from bank to bank dependent on how the bank has fared in the crisis.

3.4 Vagueness and risk narratives

Of necessity, vagueness is sometimes present within the banks' risk discussions. For example, when a bank talks about a potential future risk then it may be vague about how likely it is that the risk will transpire or about its possible consequences. However, although vagueness must be accepted as a normal feature of risk narratives, there are two aspects of vagueness that can be addressed to improve the clarity of a risk discussion:

1. it needs to be recognised that vagueness has degrees. For example, if you wish to give some idea of a man's height then saying 'He is tall' is less helpful than saying 'He is tall for a basketball player'. Contextualising the tallness with reference to basketball players removes some part of the vagueness. Correspondingly, stating in the annual report that 'This risk event has damaged our reputation' is less helpful than stating 'This risk event has damaged our reputation in the Oxfordshire area'. Of course stating the man's exact height eliminates any vagueness, but in the world of risk the complete elimination of vagueness may not always be possible; and

2. vagueness is different to ambiguity. Ambiguity arises where language is used in a way that leaves room for misinterpretation. Therefore, ambiguity can be eliminated from risk narratives if the writer ensures that information is conveyed with clarity.

3.5 Creating a risk narrative

Accepting that there does not appear to be a reluctance to provide relevant risk information, it is important to state that the inaccessibility of the risk narrative is likely to result in misunderstandings concerning the risk story that a bank is wishing to convey. It is impossible to prepare a perfect set of risk disclosures as risk is connected to unknown future events; however, it is possible to create a risk narrative that is coherent and less susceptible to being misunderstood.

This requires more than just placing the risk narrative in one location in the annual report and providing context. The risk narrative must also be logically constructed and candid in its presentation of risk and risk management information. Significantly, it must convey the prime risk discussions that have been occurring within the bank. Many organisations prepare risk registers that summarise key risks and the actions being taken to manage those key risks. Simply disclosing a summary of the risk register is insufficient, as the risk register is a static synopsis of the eventual outcome of numerous prior dialogues on risk and risk management. Risks are dynamic; it is difficult to predict how likely it is a risk will occur and what effect it may have; risks may not always be straightforward to classify; and they can have political and moral dimensions. Consequently, a risk narrative that properly provides an overarching risk story will be one that reveals these prior risk dialogues.

The risk narratives that have been produced as a result of this research are, to all intents and purposes, partial reconstructions of prior risk dialogues for each of the banks. The two provisos to this are:

1. that the risk narratives above are in summary form; and
2. it is not known how partial they are as reconstructions as they have been created solely using the risk information contained within the annual reports.

Thus, they do not stem directly from the original risk debates and risk conversations that will have been occurring continuously within the banks. This latter point is extremely important as what is undoubtedly missing from the summarised risk narratives provided above is any sense of how the managers arrived at these risk views. It would be highly surprising if there had not been competing ideas about risk within the banks and the reader needs to be given the opportunity to understand these risk debates.

4. CONCLUSIONS AND PROPOSALS

Banks are exposed to a wide array of risks and detailed risk disclosures, such as those required by Pillar 3 of Basel II, provide important information about the risk position of the bank. However, focusing solely upon the detailed risk disclosures can result in our forgetting that the essence of risk is that it concerns unknowable future events. Therefore, there is a need for an overarching narrative discussion of risk, and the fundamental objective of this risk narrative should be to 'draw together' the various risk dialogues that have been taking place within the bank. There is sometimes a tendency to over-emphasise the differences between banks and non-financial companies and this can lead to discussions focusing upon very detailed bank-specific risks. An overarching risk narrative can aid in countering this tendency.

Risk disclosure is a complex issue and it is not possible for a bank to prepare a flawless risk narrative. However, this does not mean that guidance cannot be provided to aid directors in preparing a risk narrative that is both meaningful and useful.

A coherent risk narrative should be a single document and not scattered throughout the annual report. Vagueness, but not ambiguity, should be a natural feature of a risk narrative. However, where possible the risk narrative should restrict the degree of vagueness. An awareness of tone is important as this can influence the interpretation of the risk narrative. It is common practice to advocate that managers be open and questioning when discussing risk issues internally, and this would be an appropriate tone for a risk narrative. It will be necessary to cross-reference the risk narrative to other sections of the annual report where there are related disclosures concerning, for example, the activities of the bank or the markets that it operates in.

Vitally, the risk narrative has to tell the story of the risk dialogues that have been occurring in the bank. It is inappropriate to prescribe a standard form or length for the risk narrative as the nature of the internal risk discussions will differ from bank to bank and it is these internal risk conversations that should determine the shape of the risk 'story'. This implies that banks may need to experiment with alternative narrative forms. It will also be inappropriate to delegate the creation of the risk narrative to an external organisation as they will not have been privy to the risk conversations. Delegating this task would also represent a missed opportunity as the process of crafting the risk narrative obliges managers to reflect (annually) upon their interpretation of the bank's risk discourses and this should be deemed a valuable part of the risk management process.

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