



FINANCIAL
SERVICES
FACULTY

Reporting on regulatory capital: choices for assurance

Discussion Paper

INSPIRING CONFIDENCE IN FINANCIAL SERVICES INITIATIVE



About the ICAEW Financial Services Faculty

The ICAEW Financial Services Faculty was launched at the start of 2007 to provide professional support to ICAEW's members working across the financial services sector, to influence public debates on regulation and standards affecting the sector and to become a world-class centre for thought leadership. The *Inspiring Confidence in Financial Services* initiative was established in early 2007. It 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
- 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. Alternatively contact Iain Coke at ain.coke@icaew.com.

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1. Executive summary

ICAEW was asked by the Prudential Regulation Authority (PRA) to consider how assurance on bank capital ratios and risk-weighted assets might support confidence in these important measures.

Regulatory capital ratios are key measures of the strength and resilience of banks for regulators, investors, creditors and other stakeholders. The production of capital ratios and risk-weighted assets calculations is complex. Banks and building societies¹ need to use data from a range of sources, including their risk management, credit and financial reporting systems and they need to apply a variety of judgements to these data. Designing a control system for this is similarly complex. It is important for banks and their stakeholders to have confidence in the controls, processes and governance surrounding the production of capital ratios and related information. External assurance from auditors could contribute to confidence.

This discussion paper sets out the potential benefits of assurance and discusses the issues involved in designing an assurance engagement on capital ratios and related information. This involves a series of choices, including who would be the intended users of the assurance report, what the subject matter would be and what benchmark an auditor would provide assurance against. We propose developing a standard scope for an assurance report to allow different banks to obtain assurance on a consistent basis. We do not propose any requirement for banks to obtain assurance.

Developing a standard scope involves a series of choices, including the type of subject matter and extent of assurance. These choices have a significant effect on the design of the report and on the development of guidance. This paper discusses and invites comments on these choices. Some of the choices will have a significant effect on the extent of assurance work required and associated costs, particularly over the extent of testing required on the data used in the calculations.

Our standard scope may not involve assurance being provided on the design of internal models used by banks applying internal ratings-based (IRB) approaches² as this is already subject to regulatory approval. It would, however, include the operation of those models.

Our processes and next steps

ICAEW has been discussing a potential role for assurance with the PRA, Financial Reporting Council (FRC) and large accountancy firms since 2014. We have undertaken stakeholder outreach with bank executives and non-executive directors, regulators in various jurisdictions, EU institutions, investors and analysts during the first half of 2015. We have also continued to work with the PRA, FRC and accountancy firms in developing this paper and taken input from relevant ICAEW committees. The aim of our engagement has been to help in preparing this discussion paper.

We are very grateful for the input of those who have been involved so far and are now seeking comments through this discussion paper on our analysis of the issues and, in particular, on the questions it asks, which are listed in appendix 1.

¹ References to banks in this paper are also intended to include building societies and other institutions covered by the Basel framework, and the Capital Requirements Directive IV.

² A system of determining solvency requirements in which a bank may use its own models to estimate the risk.

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Our current intention is to issue an exposure draft of guidance on assurance reports on regulatory capital in late 2015, followed by guidance in 2016.

2. Background

Use of capital ratios and risk-weighted assets

Capital ratios and the risk-weighted assets that underpin them are among the most important balance sheet measures that banks produce. Since the financial crisis, there has been much more interest in that information. Banks have had to strengthen their capital positions at the same time as facing a more restrictive definition of what counts as capital. It is often difficult and expensive for banks to raise additional capital.

Capital ratios and measures of risk-weighted assets are used for a variety of purposes by different users. Each stakeholder has their own interest in reliable measures. They are used by bank regulators as a tool for imposing standards of solvency and financial stability, as well as for assessing the risks that banks face.

External users such as investors and creditors use the information to assess a bank's stability, its financial performance, its ability to pay dividends and the likelihood of the need to raise additional capital. Return on risk-weighted assets (RoRWA) is now used by many banks as a key performance indicator in investor presentations. Capital ratios are also used as trigger points in contingent convertible debt (co-cos)³ that banks increasingly issue.

Capital ratios, risk-weighted asset calculations and RoRWA can also influence business decisions in banks, for example on business strategy, product design and remuneration. Banks need good quality management information to support decision making.

These various uses place additional significance on capital ratios and risk-weighted asset calculations, making them some of the most important performance measures for banks. They create strong incentives for banks to have robust calculations. The issuing of co-cos places particular pressures on the accuracy of these calculations if a bank gets close to the trigger point, making it even more important that banks, regulators and external users are confident in the way capital ratios are calculated.

It should also be noted that these pressures can create conflicts of interest that need to be managed. It is important that banks have strong controls, processes and governance surrounding these measures.

Basis for calculating capital ratios

Bank capital ratios are complex. They are risk-based and calculated by dividing regulatory capital by a bank's risk-weighted assets. The regulatory capital is based on the equity capital in a bank's financial statements, with some adjustments. Banks using International Financial Reporting Standards (IFRS) are required to separately disclose their regulatory capital in their financial statements. The risk-weighted assets calculation is very different, aiming to measure the risks a bank faces. Riskier assets have higher risk weights, while very low risk assets, such as central bank deposits, may have risk weights as low as zero meaning that banks are not required to hold any capital against them.

The capital rules⁴ allow banks to use either the standardised approach, where prescribed risk weights are applied to different categories of assets, or IRB approaches which allow banks to use risk weights based on their own internal models for assessing risk. These models must be approved by relevant bank regulators. Banks themselves have more information than anyone else about the risks they face and standardised approaches can oversimplify the estimation of risk⁵.

³ A bond where once a certain capital position is reached, it converts into equity so as to provide more loss-absorbing capacity to the bank in times of financial difficulty.

⁴ The basis of calculating capital ratios and risk-weighted assets are set out in the Basel capital framework agreed by the Basel Committee on Banking Supervision (the Basel Committee). It is enacted in the EU by the Capital Requirements Directives, the Capital Requirements Regulation and supplemented in the UK by PRA rules (the capital rules).

⁵ For a fuller analysis of the advantages of using internal models, see *Risk sensitivity: the important role of internal models*, Institute of International Finance (IIF), 2014 <https://www.iif.com/file/6245/download?token=jacU7WKZ>

Banks need to apply judgement in calculating their risk-weighted assets and capital ratios. Designing controls, processes and governance around capital systems is also complex, particularly under IRB approaches given the degree of judgement required, the amount of data involved and the number of information systems involved, including risk, credit and financial reporting systems. The Basel Committee is currently considering revised standardised approaches with additional subcategories which would further increase the judgement required.

The capital rules require banks using internal models to validate them. This internal validation must be done independently of the operating units to which they apply. There are no requirements under the Basel framework for auditor review of capital information. The capital ratio and risk-weighted assets calculations are not included in financial statement audit requirements.

National regulators have significant discretion over the auditor involvement in regulatory capital information and there are differences in approach. This ranges from Australia and South Africa where assurance is provided over standardised approaches and over the governance, validation and monitoring of internal models under IRB approaches, to countries such as the UK where there is no auditor review of capital ratios or risk-weighted assets, except where the regulator has identified a particular issue and therefore commissions a specific piece of work. In some jurisdictions, such as the US, while there are no external assurance requirements, the regulator tests the data quality and controls over capital as part of their examination procedures. Appendix 2 provides a more detailed international comparison.

Strong controls and governance

Banks' senior managers and their boards need to have confidence in the robustness of the processes, controls and governance over the calculation of capital ratios and risk-weighted assets. Given the importance of these measures, regulators, investors, creditors and other stakeholders should also share in that confidence. The Institute of International Finance (IIF)⁶ recognises the importance of strong processes, controls and governance to underpin confidence in bank capital measures.

While banks are continuously looking to improve the quality of their controls, processes and governance over the production of capital information, many of the stakeholders we spoke to in researching this paper observed that these are not as well developed as those for producing bank financial statements.

The Basel Committee issued in January 2013 BCBS 239 *Principles for effective risk data aggregation and risk reporting*⁷. These principles are aimed at internal risk reporting, rather than external published information, but given the common data involved, adopting the principles of BCBS 239 should enhance the robustness and reliability of external information as well as internal information. The results of the 2014 survey⁸ on progress in adopting BCBS 239 shows that banks are still working towards meeting the expectations set out in these principles.

Individual accountability and attestations

Regulators are seeking to increase personal accountability within banks. For example, the new UK Senior Managers Regime requires banks to identify the executives and non-executive directors responsible for key functions and is supported by new penalty powers which presume that the relevant senior manager is guilty of failing in their duties in the event of an institutional failure, unless the manager can demonstrate that they have taken all reasonable steps required in the situation. For banks using internal models in the EU, a senior individual is required to attest that the model use is appropriate⁹. In the UK, banks are required to agree with the PRA which individual within a Significant Influence Function (for example, the Chief Risk Officer) will provide this attestation. Basel Committee proposals, likely to come into effect in the UK in 2016, will require banks' senior management to ensure that there is appropriate review of capital disclosures and a senior manager (ideally at board level) must attest that Pillar 3¹⁰ disclosures have been prepared in accordance with internal control processes agreed by the board.

⁶ IIF 2014 *ibid*

⁷ bis.org/publ/bcbs239.pdf

⁸ 'Progress in adopting the principles for effective risk data aggregation and risk reporting', published January 2015. See bis.org/bcbs/publ/d308.pdf

⁹ Capital Requirements Directive IV.

¹⁰ The Basel 2 and Basel 3 frameworks are based on three pillars. Pillar 1 sets minimum capital requirements, Pillar 2 covers supervisory review and Pillar 3 sets public disclosure requirements.

Senior individuals in banks have significant personal responsibility for capital information. They need to be confident of the processes underpinning any attestations they make. Capital information is the result of a chain of processes involving many people and systems. Accountable individuals need confidence in this chain. Senior managers may seek assurance from either internal or external auditors to provide them with additional comfort from an independent source when making their attestations to the regulator.

3. The role of assurance

Benefits of independent assurance

Lord Hill, EU Commissioner for Financial Stability, Financial Services and Capital Markets Union, highlighted the benefits of audit, 'For it is on the judgement of auditors that the entire economy builds its confidence in companies and in markets. Unglamorous perhaps, but the rock on which trust is built'¹¹.

Assurance services provided by auditors can play a valuable role where organisations or their stakeholders need confidence in data, processes, or information. The primary role of assurance is to provide a third party, whether internal or external, with additional confidence in the subject matter of the assurance report. An independent assurance provider with relevant experience applying the highest standards to examine data, processes or information and expressing an assurance opinion provides a strong signal of reliability. The assurance process can help management enhance the quality of its internal systems and controls. External assurance is based on internationally agreed assurance standards and uses established methods for obtaining evidence and reporting. Furthermore, qualified external auditors undertaking assurance assignments are required to hold practising certificates and are subject to independence and ethical standards, continuing professional development requirements and regulatory oversight.

Assurance can bring internal benefits, for example the need for an assurance provider to obtain evidence may mean that the controls and processes will be better documented and generate better quality evidence. This improved documentation can help management with business continuity and make it easier for senior managers to find evidence to support any attestations they are required to make.

Developing new assurance models

The International Auditing and Assurance Standards Board (IAASB) developed the framework for performing assurance engagements in its standard ISAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information (Revised)* (ISAE 3000). This has been developed over the last 15 years to bring greater consistency to this continuously expanding area. It is a high-level standard and more specific guidance can be useful when it is applied for particular purposes.

ICAEW's *Assurance Sourcebook* provides a general framework for how to apply ISAE 3000 to a range of assurance engagements. This is supported by more specific ICAEW assurance guidance on particular areas to meet specific regulatory needs or market demands. For example, our guidance on providing assurance on benchmarks and indices was developed in consultation with the International Organisation of Securities Commissioners (IOSCO), the Commodity Futures Trading Commission (CFTC) and the Financial Conduct Authority (FCA) and our guidance on financial position and prospects procedures was developed in consultation with the UK Listing Authority (UKLA).

ICAEW consideration of assurance on regulatory capital

ICAEW examined the potential for providing assurance on bank capital ratios in 2010¹². At that time, our stakeholder research with investors, regulators, bank executives and non-executive directors indicated that there was little demand for regular assurance on bank capital ratios or capital information. However, we were asked by the PRA to revisit this issue. There is also increasing demand for external assurance, driven by market and regulatory requirements, for example in relation to benchmarks and indices.

¹¹ Lord Hill, speech to FEE audit conference, 23 June 2015.

¹² *Audit of banks: lessons from the crisis*, ICAEW Financial Services Faculty, 2010.

Assurance must meet some form of market demand. This may be internal demand from bank management, audit committees or boards, or external demand from regulators, investors or creditors. ICAEW cannot require that banks obtain assurance over capital ratios, risk-weighted assets or any other information and it is up to potential users to make the case for any assurance requirements. The role of this paper is to consider how such assurance might help such users and to develop a credible assurance model that could be applied consistently to ensure that there are no supply-side barriers to the provision of assurance.

Developing a scope for regulatory capital assurance

The scope of assurance will, to an extent, affect the value of an assurance report and the relative benefit of having bank capital information assured. Developing a scope involves a series of choices, each of which could provide a valid basis for assurance.

ICAEW believes that there are clear benefits in agreeing a standard scope for regulatory capital assurance so that stakeholders can easily understand what independent assurance has been provided on. This would allow assurance to be provided on a consistent basis across different institutions. It should still be possible for banks to tailor this scope for more specialist purposes.

The number of choices available in designing a scope for assurance can act as a barrier against providing assurance, with stakeholders potentially confused over what assurance can and will deliver. By developing a scope, ICAEW seeks to remove this as an actual or perceived barrier and ensure that the auditing profession is able to deliver assurance on a consistent basis if there is demand from bank management, audit committees, boards, regulators, investors, creditors or others.

Proposed approach

ICAEW believes it will be beneficial to develop a standard scope for assurance on regulatory capital information which can be useful to a range of stakeholders. We propose developing guidance that will allow assurance reports to be provided on a consistent basis.

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

4. Assurance reporting issues

The following section contains a number of high-level considerations in designing an assurance report on regulatory capital under ISAE 3000. It sets out the key choices and an analysis of the implications of different choices. These choices have implications for how we might develop guidance. Feedback is sought on each choice to help ensure that the scope developed would be useful.

Users of assurance reports

Identifying the primary users of an assurance report is the starting point in designing any assurance engagement. Assurance could be provided on a private basis to bank management, audit committees or boards. It could be intended for use both internally and by regulators as a private report. Assurance could also be intended for a wider group of users, such as investors and creditors, with the assurance reports being published alongside the capital information.

Management, audit committees, boards, regulators, investors and creditors, as potential users of assurance, may have different specific interests. Selecting a wide range of users means designing a scope which accommodates their needs. Selecting a narrow user group, such as regulators, may allow a more focused engagement but may not meet the needs of all users. We note that regulators have the power to require banks to obtain assurance that meets regulatory requirements.

Public versus private?

The benefits of private reporting are that it can allow engagements to be tailored to the particular needs of identified users and may allow for more informative reporting that refers, for example, to other information which is not in the public domain. While private reports could be made available to regulators, they would not be available to investors and creditors. This limits the extent to which assurance can provide confidence to users as only some will have access to the reports. To meet the needs of a wide range of users, public assurance reports will be needed.

Separate assurance reports

Assurance reports on capital information could be provided as a separate report, for example on Pillar 3 disclosures, or could be included in the financial statements audit report by extending this to include the capital ratio information and additional disclosures on regulatory capital.

The advantages of having a separate assurance report include that it allows a clearer understanding of the procedures that the assurance provider has undertaken on the capital information. It will also have separate materiality considerations given that this assurance report covers a different subject matter to the financial statements. A matter may be material for capital but not for financial reporting, and vice versa, given that capital ratios and risk-weighted assets are calculated using a different set of principles to those used in financial reporting standards. A separate report allows a more descriptive assurance report to be developed, for example a private long-form report to supplement a briefer public short-form report.

The advantages of extending the financial statements audit opinion to cover capital information include that it may appear clearer for users to understand and that it could simplify some of the current complexity inherent in auditor reporting in bank annual reports, where some additional disclosures are marked as 'audited' and others 'unaudited'. However, the apparent clarity may be misleading to users if there are significant differences between the audit work performed on capital information and the financial statements.

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

5. Scoping issues

The following section considers a number of detailed issues that need to be addressed to design a standard scope for an assurance engagement on regulatory capital information.

Subject matter of assurance

A capital ratio is calculated by dividing regulatory capital by risk-weighted assets. Regulatory capital is derived from audited financial statements, although there may be a number of adjustments, such as the prudential valuation adjustment, and there are different definitions of capital for regulatory and financial reporting purposes. Banks applying IFRS are required to disclose their regulatory capital¹³. These disclosures are audited in the context of their impact on the financial statements as a whole. The risk-weighted assets figure, however, is not derived from the financial statements. In addition to the Common Equity Tier 1 (CET1) capital ratio, banks produce other regulatory measures, including the leverage ratio and liquidity measures.

Controls over the risk-weighted assets calculation under both standardised and IRB approaches include a significant number of controls that are not relevant to the production of financial statement information. Those controls, therefore, are not considered as part of the statutory financial statement audit.

Assurance could be provided either over the risk-weighted assets calculation or over the capital ratio. The risk-weighted assets calculation might be of most interest to bank management and boards, given that many banks use RoRWA as a key decision making tool and key performance indicator. Regulators may also be particularly interested in this calculation given that it is a measure of aggregate risk.

Investors and creditors may be more interested in the capital ratio since this provides information about the financial stability of a bank, its ability to pay dividends, and the likelihood of it needing additional capital or triggering the conversion of co-cos from debt to equity.

Banks are also subject to a number of other regulatory measures, including on leverage and liquidity. Regulatory and capital information is disclosed in a variety of reporting, including Enhanced Disclosure Task Force (EDTF) reporting within the annual report (considered in section 6), Pillar 3 disclosure and common reporting returns (COREP) provided directly to the regulator. Each of these may be a potential subject matter of an assurance engagement. Of these measures, the CET1 capital ratio may attract the widest interest.

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

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

Controls versus the output

Assurance could be provided on the controls surrounding the capital ratio, on the calculation of the capital ratio at certain points in time, or both. Assurance on the controls, including governance, would give management, audit committees, boards and regulators confidence that they are receiving good quality information which benefits both commercial decision making and governance activities. Banks are required to comply with the capital rules at all times and effective controls and governance processes are a vital part of this.

¹³ IAS 1 Presentation of financial statements, [ifrs.org/IFRSs/Pages/IFRS.aspx](https://www.ifrs.org/IFRSs/Pages/IFRS.aspx)

Assurance on the calculation of the capital ratio or risk-weighted assets would provide confidence that the calculated numbers are materially correct in accordance with the capital rules or models approved by the regulator at a point in time, for example the year end. This could include testing of the input data, how the rules or models have been applied and any judgements made. It would provide users with additional confidence over the accuracy of published regulatory capital ratios and the risk-weighted assets.

We would expect a controls-based approach to be the most efficient for providing assurance on these calculations. Some substantive testing, such as obtaining evidence to support input data and walk-through testing of calculations, would be required to support assurance on the calculations.

The additional costs of providing assurance on both the ongoing operation of the controls over the capital ratio or risk-weighted assets and their calculation at the year end may not be significantly higher than providing assurance on either of these on a stand-alone basis. This is because providing assurance over the controls is likely to include some substantive testing of periodic calculations and providing assurance over the calculations is likely to include controls testing. These combinations may also provide the most useful information for different users.

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?

Model approval process under IRB approaches

Providing assurance over the design of the internal models of banks using IRB approaches is complex since the capital rules allow discretion over the design of internal models, and this is subject to the models being approved by the regulator.

Given the potential range of IRB approaches allowed, it is difficult to provide meaningful assurance that a bank applying IRB approaches has complied with the capital rules. While technically possible, such an opinion would, in effect, be duplicating and providing a second opinion on the model validation and approval processes of the regulator, their interpretations of the capital rules and their application of discretion.

It is possible to provide assurance that the models being used are those that were approved by the regulator, and are operating to the approved model design. The advantages of this include that it can provide a useful opinion without the assurance provider having to interpret the capital rules or provide an opinion on the regulatory model approval process. The assurance report would need to explain clearly that it did not cover the design of internal models to mitigate any expectation gap.

If there is demand for an opinion on the design of the models, this could be provided prior to regulatory approval or as part of any regulatory reviews of models that have already been approved, but would be a separate engagement not covered by our proposed guidance.

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

Testing of input data

Assurance could be provided on an 'end-to-end' basis, starting from obtaining evidence on source data and covering all aspects until the capital ratio is produced and published. Alternatively, it could cover only parts of the process, for example taking as a starting point the proper extraction of data from the books and records of a bank, but not providing any assurance over those underlying books and records.

The advantage of an end-to-end engagement is that it captures the completeness, accuracy and appropriateness of input data, as well as its subsequent application. This can be useful where there are complex data requirements. Data for calculating capital ratios are sourced not only from financial reporting systems but other information systems at banks, such as credit and risk systems. These systems are typically not subject to the same control structures as financial reporting systems which are covered by the audit of the financial statements and, for banks with US listings, by the 2002 Sarbanes-Oxley Act requirements relating to the effectiveness of internal controls over financial reporting. Additional systems and information will, however, come into the scope of the financial statement audit when IFRS 9 *Financial Instruments* comes into effect on 1 January 2018.

Restricting assurance to discrete parts of the process can be more efficient and may allow the assurance to focus on key risk areas. It can be useful where data are extracted from audited systems, from other reliable sources or where the risks relate more to the selection or application of data than to the underlying data itself. For example, the ICAEW guidance *Assurance reports on benchmarks and indices*¹⁴ sets a scope for submissions to interest rate benchmarks which requires procedures on the selection of data inputs to benchmark submissions, such as loan transactions, but does not require procedures to be performed on the underlying transactions themselves.

A further advantage of limiting the engagement to the proper extraction of data from the books and records without detailed testing of the underlying data is that it would significantly reduce the amount of work required and, consequently, the costs of providing assurance. A potential disadvantage would be that the assurance work would not detect problems with input data.

This scope decision could have implications for the choice of assurance provider. For end-to-end assurance, there are likely to be significant cost synergies for the financial statement auditor. For extraction-based assurance, there may be fewer cost barriers for another assurance provider to undertake this work.

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?

Level of assurance

Engagements by assurance providers generally take one of three forms: reasonable assurance, limited assurance or agreed-upon procedures. Reasonable and limited assurance engagements are conducted under the framework set by the IAASB in ISAE 3000. They involve the assurance provider providing an independent opinion on whether an entity has complied with an established set of criteria.

In a reasonable assurance engagement the provider expresses an opinion as to whether a bank has met certain criteria and is required to obtain sufficient evidence to support this conclusion. In a limited assurance engagement the provider expresses an opinion that ‘nothing has come to their attention’ to suggest that the bank has not met the engagement criteria. The subject matter and criteria may be similar for reasonable and limited assurance but limited assurance generally requires a lower standard of evidence.

In an agreed-upon-procedures engagement the provider performs a pre-agreed set of defined procedures and reports on the work that they have performed and the results of their testing. No assurance is given; therefore, users need to draw their own conclusions from the results. It may have limited usefulness for external parties, particularly investors, creditors and analysts and requires a higher level of sophistication to interpret.

Given the importance of capital ratios and the calculation of risk-weighted assets, banks should retain sufficient evidence to support a reasonable assurance opinion on the capital ratio. Strong controls and governance are needed over the production of capital ratios. These are likely to include generating an audit trail that provides senior managers with confidence that the capital ratios have been properly calculated and that the related controls are operating effectively. While there are many areas of judgement, particularly where internal models are used to calculate risk-weighted assets, this does not preclude a reasonable assurance opinion. For example, the audited financial statements also include judgemental areas, including on loan-loss provisions (which will become even more judgemental when the new IFRS 9 expected credit-loss model is implemented).

A reasonable assurance opinion is likely to produce the most useful information for users of assurance reports. However, limited assurance may be sufficient to satisfy any demand for assurance on interim capital ratios by extending the existing requirement for interim profits to be reported on before they can be counted as capital in interim capital returns.

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?

¹⁴TECH02/14FSF – Assurance reports on benchmarks and indices.

Detailed scoping considerations

Potential areas for consideration

It should be for the professional judgement of assurance providers to design procedures to support their opinion. However, set out below are a number of areas that could be covered in guidance on assurance over capital ratios. ICAEW welcomes feedback on this list.

- Governance over the calculation of capital ratios and related methodologies.
- The seniority and expertise of those responsible for the calculation of capital ratios, the design of related methodologies and of those who apply or approve any judgements, assumptions or adjustments in calculations.
- The level of documentation of policies for calculating capital and capital methodologies, as well as related control objectives and control procedures over these.
- The quality, reliability and reasonableness of data used as inputs to capital calculations and internal models, including related controls.
- Controls over any manual inputs into models.
- Controls over any post-model adjustments that are made which affect the risk-weighted assets calculation or capital ratio.
- The reasonableness of any judgements, assumptions and adjustments applied in calculating the capital ratio.
- Controls over any changes to capital methodologies.
- Controls over how new products are fed into the capital methodology.
- Segregation of duties between those responsible for inputting into, or calculating, the capital ratio and the relevant operational functions.
- Controls over the default rules for deciding what to do if internal models stop working effectively, for example due to major market disruption or unavailability of reliable market prices.
- The degree of review of any standing data that do not change frequently.

There is a wide range of matters that could be considered in designing the scope of an assurance report, as long as it is clear to a user what has been considered. The benefit of providing a list of matters is that it can make the scope of assurance clearer to users and bring greater consistency between the assurance reports provided on different banks' capital ratios. Appendix 3 provides more detailed scoping considerations.

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

6. Other considerations

In sections 4 and 5 we set out a number of options for designing a scope for an assurance engagement. There are a number of other areas that require further consideration, some of which may require work by other parties. We set these out below.

Comparability and the benchmark for an assurance report

It is difficult to compare capital ratios between different banks on a like-for-like basis, particularly those using IRB approaches. That is an inherent feature of a risk-based capital system.

Assurance will not resolve the difficulty of comparing information produced by banks using different approaches and models. The Basel Committee is considering how to address this difficulty, for example by: enhancing Pillar 3 disclosures; imposing capital floors; restricting the use of models; and requiring disclosures of standardised risk-weighted assets for banks using IRB approaches. Disclosure can also help users to better understand where banks' models may differ and to make their own assessments. The EDTF brings together preparers, users and auditors to drive continuous improvements in banks' risk disclosures, including disclosures of capital information. Over time, disclosures can lead to increased consistency as a consensus on the best approach can emerge, and outliers can face pressure to move towards this.

Assurance can give users more confidence that banks have calculated their capital ratios and risk-weighted assets on a consistent basis from one period to the next, that any judgements have been applied reasonably by appropriate people, and that the processes, controls and governance surrounding the calculations are robust. It can also give added confidence over the quality of the data used in the calculation process, over its reliability and that the data have been challenged. By providing more confidence in these areas, assurance may help eliminate some potential sources of inconsistency and make reasons for differences more visible.

One of the pre-conditions for providing assurance is that the user can clearly understand what assurance is provided against. This means that the assurance provider needs to have a benchmark against which they can consider the subject matter (eg, capital ratios) and draw conclusions which users can understand.

The capital rules themselves may not be a sufficiently clear benchmark for providing assurance. They require judgement and interpretations, even under the standardised approach. There is an analogy to financial reporting, where financial reporting standards set out the basic requirements but these are supplemented by accounting policy disclosures.

It should not be necessary to publish the full details of, for example, the internal models or the control procedures in order to provide assurance. However, existing disclosures may not provide sufficient detail on how capital information has been calculated or on the control environment to allow users to understand what is being assured. New disclosures may be needed, which may have an added benefit of making it easier for users to understand differences in banks' regulatory capital information.

Banks may need to work with assurance providers, regulators, investors, creditors and analysts to develop a basis for disclosing the material elements of internal models, control frameworks, policies, judgements and assumptions in sufficient detail to support an assurance opinion. While these disclosures are being developed, assurance providers could provide private assurance that would be available to management, audit committees, boards and regulators since these users have full access to the basis of preparation of capital information.

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?

Materiality

Materiality is a measure of significance. As an auditing concept it involves considering whether the inclusion or omission of information, or any errors, are likely to affect decisions of the users of information. Regulatory capital information has a different purpose to financial reporting, so the materiality considerations may be different. Regulatory requirements do not include any allowance for materiality.

Materiality is a matter for the judgement of auditors and assurance providers. Given the complexity involved in determining an appropriate level of materiality, which further dictates work effort and the amount of evidence required, the International Standards on Auditing (ISAs) have not set detailed guidance on how to quantify materiality. However, auditing standard setters are considering how materiality judgements can be made more transparent with, for example, ISA 700 (UK and Ireland)¹⁵ requiring audit reports to disclose the materiality considerations and levels used by the auditor.

Capital information is particularly relevant in the context of minimum regulatory requirements or any related triggers or targets (for example for the conversion of co-cos). This means that the closer a bank gets to any regulatory requirements or instrument triggers, the more sensitive users become to any differences in capital calculations. Smaller differences become more material and the assurance provider might judge that they needed to obtain more evidence to support their opinion.

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?

Frequency of assurance

Assurance could be provided periodically on capital information or on an ad hoc basis, for example when requested by the regulator. The advantage of periodic reporting is that it provides ongoing monitoring and can help maintain the rigour of processes over time.

While ad hoc assurance might seem to be less burdensome, in practice ad hoc engagements might be more costly than periodic assurance and may not deliver the same benefits. There are likely to be significant year-one costs for both the bank and assurance provider, for example from understanding and documenting the control environment. There are likely to be significant cost savings in the second and subsequent years. Ad hoc assurance has less potential to drive continuous improvement and maintain focus on the rigour of the process. This potentially allows problems to develop between engagements. Ad hoc reports may also be commissioned too late, after an issue has been identified, rather than helping to prevent and detect problems.

Periodic assurance is likely to be most useful to investors and creditors. If periodic assurance is to be provided, there is a choice over how frequent this provision should be. Banks produce a variety of reports at different levels of frequency. Full financial statements are produced annually and interim financial statements quarterly or half-yearly, while regulatory capital returns are submitted monthly or quarterly.

Bank financial statements are audited annually. They are required to have interim profits reported on by their auditors if they wish to include those profits in their capital returns (although this is a form of limited assurance which does not provide the same level of assurance as an audit). There may be advantages in aligning the frequency of assurance on capital information with financial reporting audit and review requirements.

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?

Cost-benefit considerations

Assurance on capital ratios should satisfy a cost-benefit test. As ICAEW is not seeking to mandate any requirement to obtain assurance but is instead proposing to develop an approach to providing such assurance, we have not undertaken a detailed cost-benefit analysis. Any assurance requirement imposed, for example, by regulators would require a full analysis.

¹⁵ International Standard on Auditing (UK and Ireland) 700 *The independent auditor's report on financial statements*, FRC 2013.

The scope of any assurance engagement will have a significant effect on costs. The extent to which the assurance provider is required to test input data may have the most significant impact on cost, given the amount of data involved for some banks. Another factor is materiality and the extent to which the amount of testing might vary as a bank gets closer to any regulatory minimum target or trigger point.

There are clear potential benefits of assurance on capital information: it forms part of a continual effort to strengthen the controls, processes and governance over the calculation of capital ratios; it provides an independent check over the reasonableness of judgements made; and it supports public confidence in these measures. The extent of these benefits will also depend on the scope of the engagement.

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

Non-audit services

Depending on the scope of an assurance engagement, there may be cost advantages in the financial statements auditor providing assurance on capital information, particularly if the scope of the assurance engagement includes input data, rather than starting from the extraction of data from source systems. There is also an overlap between the capital component of the capital ratio and the financial statements. The new expected credit-loss basis under IFRS 9 will increase this overlap. Banks are looking to increasingly use common data for these requirements.

To provide assurance the financial statements auditor must consider independence requirements based on those set out in the Code of Ethics for Professional Accountants established by the International Ethics Standards Board for Accountants¹⁶. Furthermore, the new EU audit regulation¹⁷ sets out a cap on non-audit services which can be performed by the statutory auditor with some non-audit services specifically prohibited. Assurance on capital information is not part of a financial statement audit and so would constitute a non-audit service.

Using a different independent assurance provider to the statutory auditor would have significant practical implications. It would limit the choice of audit and non-audit service providers available to banks.

In the UK, the FRC and the Department for Business, Innovation and Skills are considering how to implement the EU audit regulation. Their implementation plan is expected to be published in autumn 2015. Among other things, they are considering whether it is possible to interpret 'services required by regulation' as permitted non-audit services. This would avoid the restriction on non-audit services if there was to be a regulatory requirement for assurance on capital information.

The EU non-audit services restrictions might still be problematic for banks wishing voluntarily to obtain assurance on capital information from the auditor of their financial statements. The prohibition of additional assurance on one of the most important measures of banks' safety and soundness would seem counter-intuitive given its intention to improve audit quality. The non-audit services restrictions may need to be reconsidered in light of this.

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

Transitional considerations

If there is demand for public assurance reporting, it might be useful for banks to first have a period of private reporting to management, audit committees, boards or regulators. While controls, processes and governance may be working sufficiently well to give such individuals confidence in capital ratios, they may not be documented in such a way as to provide sufficient evidence to support an assurance conclusion. A period of private reporting would allow banks time to ensure their processes are sufficient and adequate to generate the evidence required before assurance reports are published.

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

¹⁶ See ethicsboard.org/iesba-code

¹⁷ Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities, OJ L 158, 27.5.2014, pp. 77–112.

Appendix 1: Discussion questions

- Q1: Do you agree with our proposed approach to developing guidance?
- Q2: Which users should an assurance report be designed for and what form of reporting would be most appropriate?
- Q3: What do you consider to be the most useful subject matter for assurance and why:
- risk-weighted assets
 - the CET1 ratio
 - other regulatory measures or relevant disclosures?
- 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?
- Q5: What should be the role of the assurance provider regarding model design, adherence to the capital rules, and regulatory approvals?
- 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?
- 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?
- Q8: To what extent should guidance cover the areas noted or other matters?
- 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?
- 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?
- 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?
- Q12: Do you have any views on the factors that might affect the costs and benefits of an assurance report on capital information?
- Q13: Should the provision of assurance on capital information be included as a permitted non-audit service?
- Q14: Do you have any views on transitional arrangements or on other areas that require further consideration?

Appendix 2: International comparisons

Country	Comments
Australia	<p>Banks using standardised approaches are subject to an ISAE 3000 assurance engagement. Banks using IRB approaches are also subject to assurance, but reliance is placed on regulatory approval of models, so the engagement focuses on governance, validation and monitoring.</p> <p>Regulatory returns and the controls in place during the period in which the returns were produced are assured. There has been some uptake of voluntary limited assurance reporting on Pillar 3 disclosures.</p>
France	No requirements for external audit or assurance of capital information.
Germany	<p>The German Banking Act requires that the auditor must perform procedures around the own funds requirement when performing the financial statements audit. Certain regulatory disclosures in annual reports are audited and COREP reports are subject to reasonable assurance.</p> <p>Under IRB approaches, the model design is excluded from the scope of assurance (because the models are subject to an approval process by the regulator), but controls work is performed around inputs, outputs, IT and change management.</p>
Netherlands	<p>Regulatory returns are subject to audit.</p> <p>Under IRB approaches, the model design is excluded from the scope of assurance (because the models are subject to an approval process by the regulator) but assurance is provided over controls and processes, inputs to models, model outputs, IT and change management.</p>
South Africa	<p>Certain regulatory returns made to the South African Reserve Bank are subject to assurance procedures performed under ISAE 3000. The level of assurance, however, varies across returns and within returns.</p> <p>Reasonable assurance is provided over data derived from the financial statements in selected regulatory returns, such as elements of capital. Limited assurance or agreed-upon procedures are provided over other information (eg, the risk-weighted assets) in selected returns.</p>
Spain	No requirements for external audit or assurance of capital information.
Switzerland	<p>Assurance is given to the regulator on IRB approaches but not on standardised-approach models.</p> <p>A long-form report covering compliance with Swiss law is provided to the regulator on an annual basis supported by, for those firms applying IRB methodologies, special reports on credit risk, market risk and operational risk. The long-form report does not contain an assurance opinion, but provides extensive commentary on processes and controls and an executive summary for each risk.</p>
UK	No requirements for recurring external audit or assurance of capital information. Supervisors can request a skilled person to provide assurance on regulatory reporting or associated controls and processes as part of the skilled persons review (s166) regime. This reporting is made privately to the regulator.
USA	No requirements for external audit or assurance of capital information but regulators perform detailed examinations of this information including testing controls over internal models.

Appendix 3: Scoping

Process/element	Potentially in scope	Challenging and/or areas potentially out of scope
Source data	Quality and reliability of data in source (transactional and standing data) systems.	<p>These data may be subject to audit procedures as part of the financial statement audit. However, the audit has different objectives and will not necessarily consider all data relevant to the RWA calculation (for example effective maturity).</p> <p>Assurance providers must consider:</p> <ol style="list-style-type: none"> 1. the extent to which RWA assurance can leverage audit work; 2. the incremental work required to address the data relevant to the RWA calculation; and 3. the impact of known issues in the data relevant to both financial reporting and capital.
Data processing	Extraction, aggregation and validation of source data for RWA production (eg, feeding into models and RWA calculations).	This is a key step in RWA production processes and can give rise to material errors if not performed accurately.
Risk models	<p>This would be the most judgemental and subjective part of the assurance process. Potential areas in scope are:</p> <ul style="list-style-type: none"> • model governance; • model usage: comparison of actual use to original approval (permitted asset types etc); • model validation: second-line risk control – independent model review teams; • performance monitoring: assessment of continuing appropriateness; • change management controls: process for model amendments; • testing of changes to approved ‘version’ of the model; • post-model adjustments, overlays, overrides; and • independent testing of outputs: eg, is the model generating expected outputs if approved model parameters/process/methodology are applied to ‘benchmark’ portfolios). 	<p>While this area is highly judgemental and would require specialist input, the items listed are subject to a defined framework against which the assurance provider can evaluate, and provide assurance.</p> <p>There may be practical difficulties in proving assurance on the design of internal models. Models are subject to regulatory scrutiny and approval prior to permission being granted for their use in capital requirement determinations. The purpose of assurance should not be to challenge previous regulatory decisions on model approval around model appropriateness or use. It is possible to agree and define standards against which to evaluate this area to contribute to an assurance opinion.</p>

Process/element	Potentially in scope	Challenging and/or areas potentially out of scope
Aggregation and calculation	Risk parameters (modelled or otherwise), exposure and other relevant source data and how these are transformed into RWA figures through application of the relevant rules and regulations in the calculation engines.	<p>This is a technically complex area (both operationally and in terms of applying the many rules in the capital requirements regulations and other technical standards) but there is a clear and objective way of evaluating this process against the regulatory framework.</p> <p>However, assurance on this part of the process would not provide a directly comparable level of assurance to the audit opinion on statutory accounts, which would have to be made clear to stakeholders.</p>
Reporting	<p>Various existing disclosures could form the basis of a report:</p> <ul style="list-style-type: none"> • regulatory returns (eg, COREP) • annual report disclosures • Pillar 3 disclosures. 	Regardless of which reporting vehicle is the subject of assurance, a similar level of granularity in the underlying work would be required.
Governance	Providing assurance on reported RWAs would necessitate an evaluation of the internal review, challenge and sign-off process culminating in senior management and board approval of processes and outputs.	<p>In some banks, RWA reporting may not be subject to the same rigour of board, risk and audit committee engagement as the financial statement process. This may pose a challenge to the assurance provider in their evidence gathering.</p> <p>There is not currently an adequately defined framework against which governance could be assessed in this area. Such a framework would need to be created, and it may result in a very technical description which may not be readily understandable, particularly by investors and non-expert stakeholders.</p>

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