

16th October 2015

Ms Philippa Kelly
Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA
Submitted by email to philippa.kelly@icaew.com

Dear Ms Kelly,

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the Institute's Discussion Paper *Reporting on regulatory capital: choices for assurance* ("the DP"). AFME represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

Subject to our comments below, we support the initiative to develop a standard framework governing assurance over regulatory measures provided that there is clear demand from stakeholders.

We agree with the DP's assertion that "assurance must meet some form of market demand"¹. We note that the ICAEW's previous examination of the potential for providing assurance on bank capital ratios did not identify such demand², nor are our members aware of current demand from shareholders or management for mandating such assurance. We note that the work of the industry-led Enhanced Disclosure Task Force (EDTF) involves collaboration and discussion with users of financial and regulatory information such as analysts, investor groups and rating agencies. We understand that none of those stakeholders expressed a need for further assurance over banks' regulatory calculations during the process.

Accordingly, we believe that a clear case for mandating further assurance has not been made. We encourage the ICAEW to evaluate whether demand exists and direct any further development of a standard framework accordingly.

Identifying users of assurance reports and developing a flexible framework

Should sufficient demand from potential users be identified, we believe the framework needs to be sufficiently flexible to be tailored to their needs, for example regarding subject matter, level of assurance and frequency of reporting.

¹ DP, p.8.

² *Audit of banks: lessons from the crisis*, ICAEW Financial Services Faculty, 2010.

Association for Financial Markets in Europe

London Office: St. Michael's House, 1 George Yard, London EC3V 9DH T: +44 (0)20 7743 9300 F: +44 (0)20 7743 9301

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

Company Registration No: 6996678 Registered Office: St. Michael's House, 1 George Yard, London EC3V 9DH

www.afme.eu

We understand that the DP was developed at the request of the UK Prudential Regulatory Authority (PRA). Should demand for assurance be driven by regulators, we believe that the framework needs to address their particular needs. We note that the PRA already has powers to require independent assessment and review, for example, via the section 166 regime under the Financial Services and Markets Act (FSMA) so we are not clear of the need to mandate further assurance. Furthermore, it is important that assurance is not perceived as undermining regulatory oversight and approval, or at worst seen as a transfer of regulatory responsibilities. Moreover we believe that any additional assurance should be an integrated part of the PRA's overall regulatory supervisory framework, rather than a separate, distinct part or overlapping with the regulator's responsibilities. For example, processes already in place within banks, such as internal audit, implementation of the Basel Principles for Effective Risk Data Aggregation and Risk Reporting ('PERDARR'), and ongoing management governance, oversight and challenge over regulatory calculations are already subject to regulatory oversight and supervision and so should not be duplicated or undermined through the introduction of assurance. External assurance being regarded as unrelated to or overlapping with the regulator's responsibilities could confuse, cause duplication of effort and ultimately undermine the credibility of overall regulation or at worst be seen as a transfer of regulatory responsibilities.

Model selection and similar subjects should be scoped out

We welcome the ICAEW's proposal to exclude the design of models from the scope of assurance. We believe that an assurance provider's role should not extend to assurance over whether decisions about model design, adherence to the capital rules and regulatory approvals are appropriate. Assurance over approved models would in our view involve duplication of regulators' procedures, potentially second-guessing of their views or, worse, undermining the regulator.

Next steps in consultation process and assessment of potential costs

In our members' experience, assurance over regulatory reporting can bring significant costs. We believe it critical that those costs are properly understood before finalising any framework, so that a proper cost / benefit analysis is carried out before developing an implementation plan. We would be pleased to assist you to understand potential costs.

The DP acknowledges that the development of an assurance framework is separate from its use and does not explicitly consult on the imposition of a requirement to obtain assurance. However, it does incorporate considerations relating to frequency of assurance and whether such reports should be made public as part of existing audit requirements. We recommend that further development of such a framework should be flexible with respect to such matters, and that application of the framework should be for the PRA to consult on.

Responses to individual questions

The appendix to this letter contains our responses to individual questions raised in the DP. In regard to these questions, we note that the answers often depend on who is seeking assurance and for what purpose. Accordingly, our responses at this stage are therefore general in nature and may change during the development of such a framework depending on the users and use for which any assurance is intended.

We hope the above comments and those in the appendix are useful. We would of course, as always, be pleased to discuss any aspects of the letter if that would be helpful.

Yours sincerely,



Richard Middleton
**Managing Director &
Head of Accounting Policy**



Michael Lever
**Managing Director &
Head of Prudential Regulation**

Appendix: responses to detailed questions

Background

The Discussion Paper *Reporting on regulatory capital: choices for assurance* contains 14 questions, which are produced here alongside AFME's responses for ease of reference.

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

We agree that development of a standard framework for assurance on regulatory capital information could have potential benefits. The development of a flexible framework should allow an element of tailoring according to the needs of the user of the report yet also allow for consistency.

We agree with the DP's assertion that "assurance must meet some form of market demand". We note that the ICAEW's previous examination of the potential for providing assurance on bank capital ratios did not identify such demand, nor are our members aware of current demand from shareholders or management for mandating such assurance. We note that the work of the industry-led Enhanced Disclosure Task Force (EDTF) involves collaboration and discussion with users of financial and regulatory information such as analysts, investor groups and rating agencies. We understand that none of those stakeholders expressed a need for further assurance over banks' regulatory calculations during the process.

Accordingly, we believe that a clear case for mandating further assurance has not been made. We encourage the ICAEW to evaluate whether demand exists and direct any further development of a standard framework accordingly.

In regard to the following questions, we note that the answers often depend on who is seeking assurance and for what purpose; accordingly, our responses at this stage are general in nature and may change during the development of such a framework depending on the users and use for which any assurance is intended.

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

As noted above, we believe that the ICAEW has not provided in the published Discussion Paper sufficient evidence of demand for assurance over regulatory measures and as a consequence has not identified the potential users and use of such reports. The design of such a standard scope is highly dependent on the users for which such assurance is intended.

We consider that an assurance framework should be designed for the party or parties that demand such assurance; a prescriptive framework that tries to respond to the needs of too wide a variety of intended users may result in excessive cost for the resulting benefit. Accordingly, potential users of an assurance framework should be identified and a general purpose framework be developed that is

capable of being tailored to meet their needs in order to focus on the component or area of their interest.

We believe that the ICAEW should in its consultation process articulate the parties for whom such assurance is intended and their requirements.

We believe that assurance could be in the form of a report direct to regulators; alternatively, a private report to management could be made available to regulators. In the absence of market demand, such a report should not, at least initially, be made public as we do not think there is enough evidence of market demand. Making such assurance opinions public would also be a departure from the approach taken with similar existing assurance processes, for example section 166 reports. See also our response to question 14 regarding transitional arrangements.

We believe that an assurance report over regulatory reporting should be separate from the financial statement audit opinion. We consider that commingling reports with different subject matters and potentially differing levels of assurance and frequency potentially would be unhelpful to the users of such reports and risk making unclear the level of assurance provided. Any form of assurance opinion should therefore clearly specify the subject matter of the assurance provided, as we think an expectation gap might otherwise be created between the reader of the opinion and the work undertaken as part of the assurance process.

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

- **risk-weighted assets**
- **the CET 1 ratio**
- **other regulatory measures or relevant disclosures?**

In the current regulatory landscape, in which financial institutions are monitored and regulated using many different metrics, several measures could be useful subjects of assurance, including risk-weighted assets. We note that elements of capital resources are already included within the scope of the financial statement audit. The most relevant metrics may vary depending on the institution. For example we expect that measures that would act as a binding constraint on an institution would be more likely to be considered useful subject matter for assurance in respect of that institution. The key drivers of what is the most useful subject matter will be the audience and purpose for which such assurance is intended. We consider that a standard framework needs to be sufficiently flexible to cover different regulatory metrics according to the needs of those commissioning the assurance report.

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?

Reporting on periodic calculations provides point-in-time assurance; reporting on controls provides the user with an element of assurance over the control

environment in which intra-period and future calculations are produced. We consider that the greatest gross benefit would be derived by users from assurance over both controls during the period and periodic measures or calculations. However, the costs associated with such assurance may be very significant.

To the extent that different measures are covered by a common control framework, assurance over controls during a period is likely to provide wider coverage of regulatory measures. Whilst a controls-based approach does not provide insight into the calculation itself, examination of systems, processes, controls, and governance would provide assurance over the robustness of the processes surrounding the calculations. A controls-based approach can be conducted on a sample basis, e.g., specific business lines or processes depending on the area of focus as determined by the commissioner of the assurance report.

Assurance over calculations would be highly resource intensive given the complexities in detailed calculations of RWAs, which would result in a significant cost burden. We believe, however, that some testing beyond controls would be appropriate in order to encompass, for example, capture of static data or any manual adjustments. Additionally, assurance over certain metrics might be most effectively provided by substantive testing rather than detailed testing of controls.

The extent to which providing assurance over controls or outputs would result in significant incremental cost would depend on the measures over which assurance is provided. We recommend that the ICAEW conduct a rigorous assessment of the likely costs of such assurance as part of its consultation process once demand and users have been identified in order that perceived benefits can be properly weighed against such costs. Furthermore, should the PRA expect to introduce requirements in relation to assurance, we would expect the PRA to carry out a full cost benefit analysis as part of any consultation.

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

We welcome the ICAEW's proposal to exclude the design of models from the scope of assurance. We believe that an assurance provider's role should not extend to assurance over whether *decisions* about model design, adherence to the capital rules and regulatory approvals are appropriate. Assurance over approved models would in our view involve duplication of regulators' procedures, potentially second-guessing of their views or, worse, undermining the regulator.

We believe that questions of interpretation of rules should be resolved directly between the institution and regulator as part of the supervisory process. In our view, scoping in interpretation of rules risks interposing the assurance provider between institutions and the regulator, potentially limiting dialogue between those parties. Additionally, without a process for a more formal feedback arrangement than exists today, incorporating prompt and transparent resolution of queries regarding interpretation of rules, we believe it would be difficult for an assurance provider to reach a conclusion about compliance with capital rules. Accordingly,

the assurance provider should work within the existing framework for interpretation of rules, rather than reach their own interpretation.

However, we believe that *controls* around these areas, for example, considering whether an appropriate governance framework exists and operates over interpretation of capital rules, could be incorporated into assurance over controls operating during a period as described in our response to Question 4.

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?

To the extent that regulatory measures are based on financial statement data, the processes that generate them already are subject to audit. For measures that derive from data not subject to financial statement audit, additional costs are in our view likely to be significant.

We note that with implementation of IFRS 9, additional processes, for example around credit risk models, will come in scope of the financial statement audit. We recommend that such processes not be brought into scope of any standard assurance scope ahead of the implementation date of IFRS 9.

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?

The level of assurance possible is intrinsically linked to the scope of the subject matter. While we can envisage different levels of opinion over controls, we are unsure how a reasonable assurance opinion over regulatory measures would work in the absence of a ‘true and fair view’ or similar framework.

We note that a useful summary of the advantages and disadvantages of different forms of assurance is given in Appendix 5 to the ICAEW’s *Technical Release TECH02/14FSF Assurance Reports on Benchmarks and Indices*. We encourage the ICAEW to consider the factors set out therein. Our initial view is that reasonable assurance would likely give the greatest benefit to users but needs to be considered in the context of the primary users’ needs and the costs involved. In our members’ experience, however, the costs associated with such assurance over controls or outputs can be significant and we reiterate the need for a rigorous evaluation of potential costs. An agreed-upon procedures framework could be replicated from entity to entity, which would allow for greater efficiency and comparability of reporting.

We believe that a standard framework should be sufficiently flexible for the level of assurance to be tailored according to the needs of the user of the assurance report.

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

We believe that the proposed framework should ensure an efficient approach to assurance; accordingly, we suggest that any such framework include guidance about how external assurance providers can leverage processes already in place within banks, such as internal audit, implementation of the Basel Principles for Effective Risk Data Aggregation and Risk Reporting ('PERDARR'), and ongoing management governance, oversight and challenge over regulatory calculations.

Consistent with our response to Question 5, we believe that "the reasonableness of any judgments, assumptions and adjustments applied in calculating the capital ratio" should be excluded from the scope of any such engagement. We have not identified other areas to which such a framework should be extended.

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?

We agree that guidance would need to be provided around information that is disclosed as part of the *assurance opinion* to ensure that caveats and assumptions can be articulated consistently and a standard framework would assist with comparability in this area.

We would note however that, even with a standard assurance framework, it will be challenging to achieve comparability between different assurance reports. Differences in business models between financial institutions and the extent of interpretation and judgment required to apply capital rules will give rise to some degree of diversity in their application. As noted in our response to Question 5, without a process for prompt and transparent resolution of queries regarding interpretation of rules, we believe it would be difficult for an assurance provider to reach a conclusion about interpretation of capital rules. We note that significant work has been undertaken in the recent years to improve banks' disclosures, e.g., via the EDTF, which in our view is a more effective way of addressing comparability in that regard.

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?

While we acknowledge that proximity to breach of a binding regulatory constraint would increase the importance of a particular regulatory measure (see also our response to Question 3), we believe that the extent of procedures to be performed should be a matter of judgement for the assurance provider.

As the DP acknowledges, regulatory requirements generally do not include an allowance for materiality. As noted in our response to Question 7, we are therefore unsure how a reasonable assurance opinion over regulatory measures would work in the absence of a ‘true and fair view’ or similar framework. Materiality considerations may therefore be difficult to include in assurance reports, given the nature of regulatory reporting and the need for assurance procedures to be tailored to respond to specific circumstances.

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?

As noted in our response to Question 1 we believe that a clear case for mandating further assurance has not been made. We further believe that there are both advantages and disadvantages to assurance being provided on either a periodic or non-periodic basis. Non-periodic reporting could be determined in a risk based manner, for example, based on consideration of operational complexities of a bank, the use of internal approaches, regulatory oversight including areas of focus that warrant further independent examination, and proximity to regulatory thresholds such as minimum regulatory requirements. We note that the PRA already has powers to direct banks to obtain assurance, for example via section 166 of FSMA.

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

The extent to which scoping and reporting decisions affect the benefit of such an assurance report will depend on the audience for which the report is designed. Inclusion of judgemental areas in scope, for example around adherence to capital rules, would necessitate a significant increase in experience requirements for assurance providers, which would likely drive up costs and potentially make implementation difficult.

Assurance over the calculations would be highly resource intensive given the complexities in detailed calculations of RWAs. This would result in a significant cost burden. As set out in our response to Question 4, a predominantly controls-based approach could help to mitigate some of the costs, especially if conducted on a sample basis e.g. focusing on the area of interest for the commissioner of the assurance, or focusing on specific business lines and portfolios. Accordingly, this would help to deliver value to users in a manner more proportionate to the costs involved. We would urge greater consideration of the range of costs and benefits prior to any further discussion or consultation on mandating such an assurance regime.

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

We believe that there would be significant potential to leverage financial statement audit work performed by an assurance provider; accordingly, such assurance should be included as a permitted non-audit service, whether such reporting is periodic or ad hoc, in order to ensure efficiency and to avoid duplication of effort. Were an assurance provider other than an institution's auditor be engaged to provide assurance over regulatory reporting, the significant set-up costs that would be incurred would in our view significantly affect the cost / benefit analysis.

Further, to the extent that the provision of assurance over regulatory measures constitutes services required by national legislation/regulation, such services should not be subject to limitations on permitted non-audit services.

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

We believe that transitional arrangement requirements will depend on the users of the report and that a broad-based framework should be sufficiently flexible to accommodate such transitional arrangements as are required. As a general point, we note that institutions and assurance providers would need adequate time to prepare and on the part of assurance providers allow them time to develop technical expertise.

We encourage the ICAEW to further consult on what preparation would be necessary as part of further consultation as and when the use of a framework is made clearer. Transitional arrangements may vary depending on the subject matter of assurance: some metrics, such as the Leverage Ratio, are more aligned to financial reporting than some other regulatory metrics and as such may be a useful 'test bed' for testing implementation of a standard framework.

In our view, assurance opinions should, at least initially, not be made public. We recommend that a private reporting regime should be implemented prior to any requirement for publication. This would enable 'road-testing' before a wider rollout, including assessment of whether public reporting would present any significant risk.