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Lab project report: Presentation of market risk disclosures

February 2013

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References made in this report to views of 'HSBC' and 'investors' refer to the individuals from HSBC and investment community organisations that participated in this project. The term 'investors' is used as shorthand to refer to participants in this project, which include a broad range of individuals in their capacity as investors or their role in analyst organisations that work in the interest of investors.

Project background

When it was established, one of the primary objectives of the Financial Reporting Lab (the Lab) was to help market participants develop innovations in corporate reporting. It was envisaged that such innovations would primarily be made through voluntary practices that could be adopted within current requirements, though some innovations favoured by market participants may need changes in requirements to enable their adoption.

Some of the topics discussed relate to:

- taking forward the theme of identifying and helping companies to cut clutter from their reporting;
- presentational aspects of reporting to make important information more accessible; and
- opportunities for innovation within the UK government's proposed revisions to narrative reporting requirements.

When speaking with companies about specific topics of interest for Lab projects, the Lab sought to explore how certain of these themes and developments were being considered by companies and perceived by the investment community. HSBC volunteered to participate in a project to look at changes made to its risk disclosure during 2011. Specifically, HSBC wanted to discuss with investors whether separating static policy information from current measures of key risk figures and changes to assumptions has been effective in clarifying or improving the usefulness of the bank's risk disclosure.

Reflecting this, the Lab designed a project to explore how these changes are perceived by the investment community, focusing on the disclosure of market risk to illustrate the change in presentation. The Lab also asked investors to comment on aspects of the content of market risk disclosures and how these disclosures are used and best presented in practice.

In conducting the project, the Lab involved members of HSBC's reporting function as well as members of the investment community in a series of interviews.

The findings of this report were mainly discussed in the context of the banking sector; however there are clear messages for all those with significant market risk exposure and indeed all those involved in corporate reporting.

What is the Lab?

The Financial Reporting Lab has been set up by the Financial Reporting Council (FRC) to improve the effectiveness of corporate reporting in the UK.

The Lab provides a safe environment for listed companies and investors to explore innovative reporting solutions that better meet their needs.Lab project reports do not form new reporting requirements. Instead, they summarise observations on practices that investors find useful to their analysis and encourage companies to consider adopting the practices if appropriate in the context of their own reporting.

Find out more about the Lab including information about other projects at: http://www.frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab.aspx

Do you have suggestions to share?

The Lab encourages readers of this report to provide comments on its content and presentation. As far as possible, comments will be taken into account in shaping future projects. To provide comments, please send us an email at: FinancialReportingLab@frc.org.uk

Summary of project process and observations

Summary of project process

Beginning with its 2011 Interim Report, HSBC changed the structure of how it presents its risk disclosure. The updated presentation moves a significant amount of recurring information detailing static policies and procedures related to its risk function into an appendix immediately following the primary risk disclosure. The result of this change is a primary risk disclosure that is focused on current period results and dynamic risk trends facing the bank and the industry.

Refer to the comparison of disclosures from HSBC's 2010 and 2011 Annual Reports in the section 'Example disclosure' (see page 6) for an illustration of the change.

Questions were developed by the Lab together with HSBC to elicit specific views from investors on the bank's presentation changes and overall disclosure of market risk. Fifteen individuals from seven organisations representing a wide spectrum of views including institutional investors, a sell-side broker and a credit rating agency, provided input on the project.

Summary of project observations

Persistent themes included:

- Investors value the focus placed by HSBC on evaluating the format and function of its risk disclosures in an effort to reduce the volume and complexity of reporting, while remaining proportionate to the bank's underlying risk exposures;
- Disclosures that are tailored to be concise and relevant to current results and exposures increase the ease of using reports by eliminating unnecessary or cumbersome detail;
- Investors were either neutral or positive towards HSBC's change in presentation to split the risk disclosure within the section of the report on risk; none believed the changes were retrograde;
- Many investors would welcome static information being moved to company websites, if this were to become permitted, but feel that clear cross referencing in the report to related information outside of the report is essential; and
- Investors focus on material assumptions and changes to policy when analysing key metrics such as Value-at-Risk (VaR). Splitting the presentation of information between policy and standing information and current information is not essential to achieve this objective, but can be helpful.

Refer to the section 'Investor observations' (see page 3) for the detail of comments made by investors.

Lab comment

In October 2012, the Enhanced Disclosures Task Force (EDTF), a group brought together by the Financial Stability Board, published a report *Enhancing the Risk Disclosures of Banks*, reflecting industry and investor views on risk reporting. The EDTF comprised participants from a range of investment organisations, credit rating agencies and leading global banks, and was co-chaired by HSBC's Chief Accounting Officer. About half of the investor participants in the Lab project were also members of the EDTF.

The EDTF report describes a number of key principles to underpin enhanced risk reporting, along with providing best practice examples of disclosure that reflect the type of information and level of granularity commonly used by investors when provided.

"Splitting the disclosure has helped us focus the reader on key developments and how we have responded. Looking ahead, we plan to maintain the separate presentation of information in the appendix."
HSBC

The EDTF's key reporting principles suggest that risk disclosures should:

- be clear, balanced and understandable;
- comprehensively reflect a bank's key activities and risks;
- present relevant information;
- reflect how a bank manages its risks;
- be consistent over time;
- allow comparability between banks; and
- be provided on a timely basis.

These principles – as they pertain to market risk disclosures – are consistent with the Lab's findings. Specific disclosure recommendations outlined by the EDTF go beyond the scope of the Lab's report. However, the Lab anticipates pursuing a future cross-sector project on the format and content of principal risk disclosure, which may build on the conclusions of this Lab project and of the EDTF.

The Lab also plans to conduct a project on accounting policy disclosure, which may build on the aspect of presenting policy information separately or integrating policies with current disclosure. It is also exploring projects that might more directly consider themes of de-cluttering reports and online or technology-enabled reporting.

Investor observations

Separation of risk policy and practices from current period analysis of risk

The overarching message from investors was that they focus on key assumptions and changes to risk policies, and that it is helpful to highlight this information in the disclosure, regardless of whether it is presented in a combined or segregated fashion.

Nearly all of the participants explicitly indicated that a company's interim and annual reports are used as valuable reference documents, and are consulted periodically for various pieces of information. Most suggested that specific sections of the reports are typically reviewed at a given time, as opposed to a general reading of the entire report. Discrete sections are reviewed and searched for specific information as it is needed. Recent examples of specific interest were provided including exposure to clients in the Eurozone or other geographic regions.

Illustrating this basis for how reports are typically used, specific feedback from the project participants suggested that market risk disclosures are an area of focus for analysis. Most indicated that HSBC's amendment to its presentation in the 2011 Interim Report was not immediately noted, however when attention was drawn to the change, investors were evenly split as to whether the amended presentation:

- Improved the clarity and usability of the risk section of the annual report by removing static information to an appendix and focusing on key indicators and risk movements during the year; or
- Neither enhanced nor hindered the quality or clarity of the risk disclosures.

Investors that thought segregated disclosure increased the clarity of the risk section also indicated that information included in the appendix was informative when first becoming familiar with the company. As this information is expected to, and typically does remain fairly consistent from period to period, some prefer it to be shown in a less prominent position in the report.

Two investors suggested that the amended presentation allowed HSBC to more clearly focus the message in its main disclosure on how the bank managed the balance sheet in response to specific risks. One investor commented that the amended presentation resulted in a separation of key VaR assumptions from actual VaR figures, slightly increasing the effort required to understand the risk position in its totality.

Other investors expressed the view that the effectiveness of any split disclosure is dependent on the level of cross-referencing provided.

Investor Views:

"We try to read every page – some more carefully than others."

"It is nice to know that policy notes and outcomes are all easily found together in one place."

"I read the policies section the first time I review a company's report. This information does not need to be read thereafter."

"As a complex global bank, we would expect HSBCs reporting to be lengthy, but value their focus on relevant disclosures."

Online disclosure of risk policies and procedures

In line with the desire for increased transparency and simplification of the printed Annual Report, over half of the investors interviewed indicated that they would like to see companies provide greater amounts of existing investor-related information on their websites.

The Lab asked whether the removal of the risk policies and practices appendix entirely from the Annual Report would be acceptable to investors. Only one expressed an objection to the proposal, citing a loss of the complete risk view in the Annual Report. Note, however, that the presentation of this information in the Annual Report is currently a requirement of International Financial Reporting Standards (IFRS).

In terms of principles for the increased use of online media for disclosure of investor information, there was unanimous agreement among the investors that any information disclosed on a company's website—particularly if it was to be removed from the printed Annual Report—would need to be clearly linked and indexed for ease of reference. Searchable .pdf files were suggested as an essential means of improving efficiency of review. As noted previously, the message from investors was that since they use the Annual Report in part as a single reference document, any online presentation and accompanying search tools need to facilitate this way in which information is used.

"One of the fundamental questions is...the use of electronic media; being able to navigate through documents and exploring what can be done to make certain standing information available on websites. We believe our disclosure creates a structure which will enable us to someday separate the information and place standing data on our website."

HSBC

Sensitivities and Stress Testing

The Lab requested feedback on another key aspect of the risk disclosures, namely that of risk sensitivity tables and disclosure of stress test results. These discussions were not bounded by the requirements of current IFRS, rather they focused on information that the investors would like to see in bank reporting generally.

Sensitivities

A majority of participants indicated that sensitivity of key risk metrics are a key part of the analysis they perform. One investor noted that understanding trend information for net interest income was particularly important "as income from deposits is a key component of the value of a bank's shares."

Similar to the disclosures of VaR, the investors noted that a robust discussion of assumptions used in the sensitivity calculations provides vital information that the figures alone may omit.

Stress Testing

Many of the investors provided additional commentary on the use of stress test information included in the risk disclosure, noting:

- Investors prefer stress scenarios that reflect "worst-case" possibilities as realistically as possible;
- A detailed discussion of assumptions used in the stress test scenarios and methodology applied is necessary for a thorough understanding of the results;
- As with the approach to VaR, stress testing for industry peers lacks consistency; and
- Though European Banking Authority (EBA) stress tests have brought a degree of comparability to stress tests, the reliability of results may be limited by the perception of country bias.

Consistent with the points made above, feedback from investors suggested that a bank might tailor stress testing to its own business operations, as well as current market conditions. It was noted, as an example, that the discussion of interest rate risk is more relevant in a period with a more dynamic interest rate environment or for a geography with greater interest rate volatility. Factors such as these may be incorporated into the test and disclosed.

Lab comment

Proposed changes to the content of the printed Annual Report – i.e. to relocate standing data to websites – are reflective of the views of investors participating in the Lab's project and were suggested as an improvement in line with recent discussions regarding the future of financial reporting. Putting these changes into practice would require thorough debate and consultation, and an amendment to currently issued IFRS.

Investor focus in reviewing market risk disclosures

The Lab specifically asked participants about the relevance of market risk disclosures to their review of a bank's Annual Report. The prevailing opinion on disclosure of the risk profile was:

- The depth and type of information contained in disclosures should be tailored to fit the size and nature of a given bank's risks; and
- Disclosures focusing on underlying risks and the bank's response to key market events should be relevant and current.

Despite calculation inconsistencies that limit comparability across the industry, understanding VaR is also important to the investment community, as it provides an indication of how management views and addresses risk.

Risk profile

To reflect the different risk profile of each bank, the investment community seeks tailored disclosures of key risks. One investor stated, for instance, that given its position as a global leader in retail banking, HSBC would be expected to have a greater level of credit risk disclosures than an industry peer that focused primarily on investment banking activities.

Many investors also note an active interest in the bank's response to current and future risks, such as the ongoing uncertainty posed by specific Eurozone countries or exposure to other sovereign debt, and stated that risk disclosures should both explain the impact of current market conditions on an entity's operations and demonstrate that emerging risks are being anticipated.

VaR disclosures

In addition to comments suggesting a benefit to presenting VaR assumptions alongside VaR figures, investors were clear that their reviews of reported information include a focus specifically on a bank's VaR result. All but one investor noted that they review VaR in detail in each published report, with a focus on trends for a single company over time, due to the divergence of practices and assumptions used in calculating VaR among industry peers.

One investor noted that gaining this understanding is so vital as to necessitate "a specific conversation with the company" after each reporting period to ensure a correct interpretation of the VaR calculation.

Views were mixed, however, as to whether the inconsistency in VaR calculation among banks should be rectified. Both HSBC and certain investors noted that an individual approach to VaR allows each bank to represent its own risk position and how management analyses risk across its portfolio.

Other investor suggestions for characteristics of robust VaR disclosures generally, included:

- Disaggregation of VaR figures to represent how the business is managed (i.e. by product, business line, geography, etc).
- Robust description of VaR assumptions used-such as look-back periods, confidence intervals and time horizons – and a description of back-testing performed.
- Reconciliation between VaR and other financial disclosures – namely regulatory capital and the IFRS balance sheet and income statement.
- Quarterly VaR disclosures – Q1 and Q3 data is currently lacking from the disclosure of most large UK and French banks, but is largely available for other European and American peers.

Some limitations of VaR as a meaningful metric were mentioned by two of the investors, who indicated that "recent surprises" at some banks raise the question of whether VaR models can adequately forecast risk exposure. Their doubts about the effectiveness of VaR notwithstanding, both of these investors still indicated the importance placed on robust disclosures and understanding a bank's VaR calculation.

"For material items, we highlight what has changed during the year in the main disclosure...There may be a risk factor of particular interest during a period. We try to shine a very bright light on that area."
HSBC

Lab comment

Risk disclosures are currently required on a half-yearly basis. Requests for more frequent risk disclosures – i.e. quarterly – reflect the views of some of the investors interviewed.

There is tension between encouraging longer term views on investment and quarterly reporting, and this has been described in Professor John Kay's review 'UK equity markets and long-term decision making'. However, some investors view increased transparency derived from more frequent risk disclosures as a favourable step in the direction of re-building trust and confidence in banks, as well as demonstrating the importance of stewardship.

Example disclosure: illustration of the change in presentation

HSBC Holdings Plc 2010 Annual Report: combined reporting of policies and practices, along with current year position.

2010 Report of the Directors: Operating and Financial Review – Page 148

Credit spread risk

(Audited)

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VaR for those portfolios on which it is calculated.

< Policies and practices

At 31 December 2010, the Group credit spread VaR was US$41.9m (2009: US$72.7m). The decrease arose from the effect of volatile credit spread scenarios rolling off from the VaR calculation.

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within our corporate loan portfolio and so enhance capital efficiency. The mark-to-market of these transactions is reflected in the income statement. At 31 December 2010, the credit VaR on the credit derivatives transactions entered into by Global Banking was US$12.3m (2009: US$13.8m).

< Current year discussion

Gap risk

Even for transactions that are structured to render the risk to HSBC negligible under a wide range of market conditions or events, there exists a remote possibility that a significant gap event could lead to loss. A gap event could arise from a significant change in market price with no accompanying trading opportunity, with the result that the threshold is breached beyond which the risk profile changes from no risk to full exposure to the underlying structure. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, the market for a specific investment becomes illiquid, making hedging impossible.

Given their characteristics, these transactions make little or no contribution to VaR or to traditional market risk sensitivity measures. We capture their risks within our stress testing scenarios and monitor gap risk on an ongoing basis. We regularly consider the probability of gap loss, and fair value adjustments are booked against this risk.

< Policies and practices

We did not incur any material gap loss in respect of such transactions in 2010.

< Current year discussion

HSBC Holdings Plc 2011 Annual Report: policies and practices split into an appendix.

2011 Report of the Directors: Operating and Financial Review

Credit spread risk

(Audited)

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within our corporate loan portfolio and so enhance capital efficiency. At 31 December 2011, the credit VaR on these transactions was US$6.6m (2010: US$12.3m). The mark-to-market of these transactions is reflected in the income statement.

Gap risk

During 2011 gap risk continued to be managed down. We did not incur any material gap loss in 2011.

< Current year discussion Page 165

Appendix – Risk policies and practices

Credit spread risk

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VaR.

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within the corporate loan portfolio and so enhance capital efficiency. The mark-to-market of these transactions is reflected in the income statement.

Gap risk

Even for transactions that are structured to render the risk to HSBC negligible under a wide range of market conditions or events, there exists a remote possibility that a gap event could lead to loss. A gap event could arise from a significant change in market price with no accompanying trading opportunity, with the result that the threshold is breached beyond which the risk profile changes from no risk to full exposure to the underlying structure. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, the market for a specific investment becomes illiquid, making hedging impossible.

Given their characteristics, these transactions make little or no contribution to VaR or to traditional market risk sensitivity measures. We capture their risks within our stress testing scenarios and monitor gap risk on an ongoing basis. We regularly consider the probability of gap loss, and fair value adjustments are booked against this risk.

< Policies and practices Page 200

Project methodology

Background

The overall objective of this project was to explore the views of market participants on HSBC's segregated presentation of risk information between current results and static policies and practices, as well as other views on useful presentation of risk disclosures.

The Lab worked with HSBC to develop a set of questions that served as the basis for discussions with investors. A full text version of the company's 2011 and 2010 year-end market risk disclosures, and its 2011 half-year market risk disclosure were provided alongside the questions to help illustrate the various points raised.

The most significant portion of the project research was gathered during a series of mainly face-to-face discussions between the Lab, project participants and HSBC, taking place from early 2012 into the summer. The objective of these discussions was to reflect on the various considerations noted by investors as being important relative to their analysis of risk disclosures, and obtain explanations where possible of how information is used, so that this could be reported on by the Lab. Discussions lasted on average just over an hour.

In this project, the Lab facilitated the discussion with investors to obtain their views on the various topics without navigating to an agreed answer on each question or striving for consensus among participants. The meetings were conducted interactively, with focus placed on aspects that participants showed a relatively greater interest in, to understand better whether and how various characteristics of information are used by individual investors.

The section of this report on 'Investor observations' (see page 3) reflects responses to the questions raised as well as additional comments offered by those interviewed.

Investment community participation

During the course of this project, seven investment organisations provided input to the Lab, covering a wide spectrum of viewpoints. In all, views were obtained from 15 individuals.

The following organisations contributed views from the investment community in their capacity as investors or other analyst organisations that work in the interest of investors:

- Alliance Trust
- Barclays
- Blackrock Investment Management
- CFA Institute
- Fidelity International
- Fitch Ratings
- M&G Investments

All members of the investment community involved in this project have specialised knowledge in the financial services industry, particularly regarding retail and investment banking.

Approximately half of the investors that participated in the project commented from the perspective of directly following HSBC; the others commented more generally from the perspective of analysing banks.

This project report summarises points raised by investors as being important to their analysis, however, it is the responsibility of each reporting company to ensure compliance with relevant reporting requirements. Companies are encouraged to consider whether the observations in this report are material and of relevance in the context of the company's own financial reporting.

Project context: focusing on what is important

Recent FRC guidance published in *Cutting clutter: Combating clutter in annual reports (2011)* and *Financial Reporting Review Panel: Annual Report 2011* and *Financial Reporting Review Panel: Annual Report 2012* has encouraged all those involved in preparing financial reports to exercise judgement to determine and apply a quantitative threshold and qualitative assessment for materiality in relation to disclosures.

A more rigorous approach to materiality judgements might result in financial reports that are more meaningful, focused and relevant to investors because inconsistencies and superfluous material will have been avoided. Clutter undermines the usefulness of annual reports and accounts by obscuring important information and inhibiting a clear understanding of the business and the issues it faces.

In July 2012, the FRC, in partnership with the European Financial Reporting Advisory Group (EFRAG) and the Autorité des Normes Comptables (ANC), published a Discussion Paper *Towards a Disclosure Framework for the Notes*. That paper forms an essential part of the full disclosure picture but is deliberately limited in scope. The FRC continues to consider how a disclosure framework might contribute to improvements in corporate reporting, and has recently published a Discussion Paper *Thinking about disclosures in a broader context* which considers disclosures more holistically.

Finally, the conclusions reached in The Sharman Inquiry: Going Concern and Liquidity Risks, also published in July 2012, describe the importance of company stewardship in evaluating the liquidity and solvency risks in financial reports. In January 2013 the FRC published a Consultation Paper Implementing the Recommendations of the Sharman Panel that puts forward the FRC's related proposals for guidance on going concern together with a supplement for banks. Comments received in this lab project related to disclosure of stress testing scenarios are consistent with the findings of the Inquiry, which encourages reporting detail of tailored measures taken to evaluate going concern risks.

Other reports published by the Lab recently:

November 2012:
Debt terms and maturity tables

November 2012:
Operating and investing cash flows

September 2012:
Net debt reconciliations

June 2012:
A single figure for remuneration

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