SVERIGES RIKSBANK

Economic Commentary

Transparency for efficiency and financial stability

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Economic Commentaries

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Summary

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The financial system needs to be transparent for investors to be able to obtain information about underlying risks. During the global financial crisis, however, it became clear that there were problems with a lack of transparency. Many banks experienced liquidity shortages and investors were unable to assess which banks had significant payment problems. As banks had significant links to each other, this caused confidence problems and contributed to stress in the financial system. As a result, the Basel Committee undertook major revisions to transparency requirements after the financial crisis.

New risks are emerging in the financial system that investors and other stakeholders need to understand as they evolve. Climate change is one source of such risks. In order to effectively measure and manage climate-related risks, governments and international organisations need to cooperate, develop consistent standardised frameworks and increase transparency. Banks also have a major role to play in this work and need to improve their transparency on climate-related risks. Improved transparency can also contribute to economic development and reduce the risk of financial crises.

[1] Thanks to David Forsman, Mattias Hector and Camilla Ferenius for valuable comments. The views expressed in Economic Commentaries represent the authors' own opinions and are not to be regarded as an expression of the Riksbank's view on the issues concerned.

1 Introduction

In this Economic Commentary, we describe the evolution of transparency in the global banking system, why transparency is important, and the effects of insufficient transparency on financial stability. We then discuss climate risks and the work being done internationally to promote transparency of climate-related information.

Transparency is important because the parties in the financial system need to trust each other in order for the system to fulfil its basic functions - mediating payments, converting savings into investments and managing risks. For example, a bank that loses the confidence of depositors could suffer a run on withdrawals that could quickly lead to the bank's default. Trust requires access to true and fair information, so that all stakeholders can form an accurate view of the risks involved in engaging with a counterparty. There must then be sufficient transparency. But transparency is not just about the supply of information. Nor does more information automatically mean greater transparency. It is also important that the information provided is relevant and understandable to the counterparty.

2 Transparency in the financial system

Insufficient transparency makes it more difficult for investors and other stakeholders to assess the financial position of banks and the risks they take. This leads to weakened market discipline, which means that participants do not have information on the risks that are building up, and can contribute to financial stress and, by extension, to the emergence of financial crises.

A fundamental problem in financial markets is when the parties involved have different, or asymmetric, information in a transaction.[2] This is the case, for example, when a bank issuing a security has more information about the risk of the security than an investor. Since the investor lacks full knowledge of the risk, they cannot fully differentiate between the prices of securities issued by banks that take a low risk and those issued by banks that take a high risk. If investors do not have sufficient information on the nature of the risk, a high-risk bank will not be "penalised" with a higher funding cost. However, a lack of transparency does not necessarily mean too little information. Information that is not material may also make it more difficult to accurately assess banks' risks. The information provided must therefore be clear, relevant and understandable to the counterparty, which also requires it to be harmonised and comparable. Without sufficient transparency, it is also not possible for investors to obtain information on the underlying risks of a company's operations, making it more

[2] Akerlof described the problem of information asymmetry as early as 1970 in "The market for lemons". Akerlof described a market for a product where the seller has an information advantage over the buyer regarding the quality of the product. A classic example is used cars - so-called "lemons" where the seller has much better knowledge of the product than the buyer. Akerlof showed that information asymmetry can hypothetically collapse the entire market or shrink it to a negative selection of low-quality products.

expensive for financially strong companies, relative to their risk profile, to obtain funding. This can then contribute to lower investment and growth than would otherwise have been possible and to greater risk in the financial system, which in turn increases the likelihood of financial stress in the banking system.

Deficiencies in the availability of accurate information can also spread and exacerbate financial stress already present in the system. Without sufficient transparency about individual banks' risk exposure and links to different sectors and companies, it becomes difficult for investors to assess whether problems arising in an individual bank can be confined to that bank, or whether there is reason to believe that other banks also have similar problems. There is then a risk that even the strong banks will be affected. Through this spill-over effect, inadequate transparency can contribute to problems for the financial system as a whole. During the global financial crisis of 2008, this insight became very clear when it was discovered that banks' risks could not be observed and measured well enough.

3 Higher transparency requirements after the financial crisis

One lesson from the global financial crisis was that banks around the world needed to become more transparent. Banks' operations and financial products had been becoming more complex for some time. This made it more difficult for investors to assess the risk profile of banks. This weakened market discipline was a contributing factor to the global financial crisis. After the financial crisis, the Basel Committee, which develops global standards on capital and liquidity, undertook a major revision of the transparency requirements for banks - Pillar 3. Transparency requirements are now higher in several areas such as credit risk, market risk, liquidity risk and operational risk.

Banks' transparency requirements and Pillar 3

The purpose of imposing regulatory requirements on banks is to ensure that they have the capacity to manage losses. In this way, the impact of financial crises on the banking system and society can be prevented and mitigated. The Basel Committee on Banking Supervision develops minimum requirements to be applied to banks worldwide. The requirements are usually divided into three groups, or pillars. Pillar 1 consists of minimum capital and liquidity requirements that apply generally to all banks. Pillar 2 consists of bank-specific requirements, in addition to the minimum requirements in Pillar 1. These are set by the respective supervisory authority on the basis of each bank's specific risk profile. Pillar 3 consists of requirements for banks to disclose information about their own operations so that the bank's risk profile can be assessed - in other words, transparency requirements.

A lack of transparency contributed to the crisis

During the crisis, many banks experienced severe liquidity problems, prompting central banks around the world to implement liquidity support measures. The problems arose because many banks had taken large liquidity risks and were unable to pay. As the transparency regarding these risks was virtually non-existent, they could build up without investors having the opportunity to react in time.

For credit risk, too, there were clear problems linked to a lack of transparency during the financial crisis. Banks' operations and products had become increasingly complex over a long period of time, making it difficult for investors to assess the credit risk of financial products, such as securitised home loans.[3] When turbulence hit the property market and property prices fell, investors found it difficult to assess credit risk because they had too little information about how these loans were actually constructed. This led many investors to choose to divest these instruments which then lost value. One factor contributing to the problems was that banks used external credit rating agencies to assess the credit risk of different instruments. In many cases, their assessment turned out to be wrong and instruments that had been rated as low credit risk, i.e. AAA, were in reality much higher credit risk. Overall, this led to a loss of confidence in banks and they suffered large loan losses. The experience of the crisis was thus that accurate information on asset quality and the liquidity situation of banks is one of the most important factors in maintaining confidence in the financial market and assessing financial stability.

Shortly after the onset of the financial crisis, the Basel Committee therefore undertook a major revision of Pillar 3, requiring banks to disclose more comprehensive and detailed information on financial risks. Much of the information has also become easier to compare across banks and countries as they now have to use the same risk measures and standardised reporting templates. The Basel Committee's review had a broad focus and covered several risk areas, such as credit risk, market risk and liquidity and operational risk. An important part of the review concerned liquidity risk, with new disclosure requirements on banks' short-term (LCR) and long-term (NSFR) solvency.[4] The work continued for several years and the regulatory changes have been introduced in stages. The final stage of the revision is to be implemented from 1 January 2023.[5] The Pillar 3 transparency requirements are based on a proportionality principle whereby larger and more complex banks must disclose more information.[6] When and how the final stages of Pillar 3 will be implemented in the EU is currently under negotiation. [7]

[3] Problems in so-called subprime loans, i.e. securitised mortgages, were a contributing factor to the emergence of the financial crisis.

[4] The liquidity coverage ratio (LCR) aims to ensure that banks have sufficient liquid assets to cope with short-term liquidity stress. The net stable funding ratio (NSFR) is a measure that relates a bank's stable funding to its illiquid assets and aims to promote the resilience of banks over a longer period of time.

[5] See Pillar 3 disclosure requirements - updated framework (bis.org).

[6] See Appendix 1 for a description of Pillar 3 and its contents.

[7] The implementation of the final Basel 3 in the EU is part of the "Banking Package 2021: New EU rules for more resilient banks and better preparedness for the future".

The increasing information requirements become clear if you look, for example, at the major Swedish banks where the financial reports have become increasingly longer since the crisis.[8] The growing complexity and size of large banks also reflects an increased need for information. The size of the three major banks, measured in terms of balance sheet total, increased significantly from the year 2000 (SEK 915bn) to 2021 (SEK 3,133bn). In addition to the annual report, banks are required to produce a specific report on their risk and capital situation (Pillar 3 report).[9] Banks also produce so-called sustainability reports which include some environmental information.[10]

4 Need for transparency on climate risks

The financial system plays an important role in the climate transition and there must be sufficient transparency on climate related risks. Authorities and banks must continue enhancing transparency and support green investments. Without credible information, there is a risk that green investments will not be made, affecting the climate transition and the development of a sustainable economy.

Transparency on climate risks and sustainability is under development

Knowledge about the impact of climate change on people's living conditions and the economic system is growing all the time, but it is still not good enough. This is also true of its impact on the financial system. This is a serious shortcoming, both because there is reason to believe that the negative effects on the financial system could be significant, and because the financial system itself has an important role to play in mitigating and managing the effects of climate change. Financial reporting, like international accounting rules, has been harmonised for a long time. However, sustainability reporting is still not standardised and lacks harmonised definitions, making it difficult to compare and use sustainability reports.

Internationally, intensive work is therefore under way on risks related to sustainability and climate change, in which the Riksbank is actively participating.[11] Several parallel tracks with new sustainability standards are being developed by various organisations to increase transparency on climate-related risks. Different standards are being developed in the EU, globally and in the United States. Table 1 below provides an overview of ongoing transparency projects on sustainability and climate.

[8] For the three largest banks in Sweden, the number of pages in the annual report has more than doubled from an average of 104 in 2000 to an average of 261 pages in 2021.

[9] For 2021, the average number of pages in the risk report is 98 for the three largest Swedish banks.

[10] Sustainability reports are in some cases included as part of the annual report. Sustainability is an umbrella term that shows how a company takes into account environmental, social and corporate governance issues. The term ESG (environmental, social and governance) is often used to describe sustainability.

[11] See the Riksbank's Climate Report (2021) for a description of the Riksbank's climate-related work.

Table 1. Overview of sustainability standards

	TCFD	NFRD	CSRD (ESRS)	EU pillar 3	IFRS sustainability reporting
Standardised reporting	No	No	Yes	Yes	Yes
Quality assurance (audit)	No	No	Yes	No	No
Implementation	2017	2014	Planned for 2023 with first reporting in 2024.	Has applied since mid-2022 with first reporting in 2023.	Standard is expected to be ready by the end of 2022. Unclear when implementation will take place in countries but voluntary use is supported.
Jurisdiction	Global	EU	EU	EU	Global, not the US

Since 2017, the Task Force for Climate-related Financial Disclosures (TCFD) has made recommendations for climate-related risk disclosures, but compliance is voluntary.[12] The Basel Committee has also developed principles on how banks should manage climate risks.[13] The European Banking Authority has recently introduced requirements for increased transparency on climate-related risks in the EU Pillar 3. In short, this means that European banks must disclose both physical risks and transition risks in a standardised format.[14] European companies are also subject to the Non-Financial Reporting Directive (NFRD), which requires certain large companies to disclose environmental and social sustainability factors in a sustainability report. Work is currently under way to replace the NFRD with a new directive, the Corporate Sustainability Reporting Directive, CSRD, which covers all large companies and all listed companies in the EU, introduces detailed sustainability disclosure requirements, standardises the information and makes it comparable. The information will then need to be audited by an external party.

One problem with the existence of several parallel international standards on sustainability is that it can be difficult to know which requirements should apply and that different requirements in different standards are not aligned with each other. They also need to use definitions in the same way. Many banks and companies are active internationally and may therefore need to comply with multiple standards. It is therefore important that the various organisations producing the new regulations, such as the

[12] The TCFD was created in 2015 at the initiative of the Financial Stability Board (FSB) and its recommendations were developed through private sector collaboration. Many of the sustainability standards now under development build on the work of the TCFD.

[13] See Principles for the effective management and supervision of climate-related financial risks (bis.org).

[14] These include both physical risks, such as sea level rise, which could affect mortgage or property prices, and transition risks, which could affect the ability of companies in carbon-intensive industries to obtain loans. Banks will start disclosing these risks under Pillar 3 in 2023.

IFRS Foundation, EFRAG, the European Banking Authority and the European Commission,[15] work together to ensure that the information is useful and understandable to stakeholders.

Greenwashing is a transparency problem

Many consumers and companies are demanding sustainable and green products. This can lead companies to portray certain products as more environmentally friendly than they are, so-called greenwashing. For example, a fund may market itself as environmentally friendly but not invest in green companies to any great extent. Environmental arguments are used in marketing to take advantage of growing consumer interest in the environment. Such types of greenwashing are a problem often discussed around climate transparency.

In some countries, greenwashing has become such a widespread problem that new regulatory and transparency requirements have been developed. In the EU, for example, elements of the Green Taxonomy Regulation have been introduced as part of the EU Action Plan to finance sustainable growth.[16] Since last year, the EU Sustainable Finance Disclosure Regulation has also been in force, regulating how fund management companies and financial advisors should disclose sustainability factors. Finansinspektionen, the Swedish Financial Supervisory Authority, has also identified greenwashing as a major risk in the financial sector.[17] Without credible information, there is a risk that green investments will not be made, affecting the climate transition and the development of a sustainable economy. We therefore need to continue to develop clear rules on how companies can classify and market products, and there must be effective supervision and enforcement of the rules.

5 Concluding remark: It is important to continue working on transparency

Improved transparency contributes to economic development and reduces the risks of financial crises. Work to develop better transparency requirements has been ongoing for a long time. For example, the Riksbank has long advocated higher transparency requirements for the major Swedish banks with regard to various financial risks. The Riksbank has had a driving role in this development towards greater transparency and harmonisation of financial information. One of the Riksbank's tools has been recommendations directed at the banks in the Swedish financial system through the Financial Stability Report.[18] One risk area where the Riksbank made recommendations early on was liquidity risk, where the Riksbank described how well the major Swedish banks

[15] The IFRS Foundation is a global not-for-profit accounting organisation and its Sustainability Board ISSB is responsible for producing the IFRS Sustainability Report. EFRAG is the European Financial Reporting Advisory Group and develops the European sustainability reporting standard called ESRS, which is based on CSRD.

[16] The Taxonomy Regulation contains rules defining when an economic activity is considered environmentally sustainable.

[17] https://fi.se/sv/publicerat/nyheter/2022/fi-granskar-hallbara-fonder/

[18] See Financial Stability Report 2012:1.

were meeting liquidity measures. Another area is doubtful loans, where the Riksbank has emphasised that transparency should be increased so that investors can better understand the risks and quality of the banks' loan portfolios. [19]

One current area where the Riksbank would like to see improved transparency is in climate-related risks. It is important that banks disclose their exposures to climate risks.[20] Until a new regulation is in place for climate-related risks, voluntary transparency is therefore a first step. In order to manage climate-related risks effectively, authorities and international organisations need to work together to develop consistent standardised frameworks and increase transparency.

Banks also have an important role to play in this work. They should be proactive and already be as transparent as possible. An effective transparency framework supports the climate transition and can eventually enable better and greener investments. The major Swedish banks are producing sustainability reports and are moving in the right direction, but more can be done. For example, information on climate footprint and so-called scope 3 emissions[21] as well as related key figures that can be used to assess progress towards set targets. Although the new sustainability standards are not yet fully developed, banks should strive to provide as much information as possible. Once frameworks are in place and more data is available, transparency can then continue to improve. At this stage, improved climate transparency should be seen as complementary to regulation and specific requirements. Improved transparency also provides incentives for banks not to take too much risk and reduces the likelihood of stress in one part of the banking system spreading to other parts.

[19] See O. See O. Fredriksson and N. Frykström (2019), "Bad loans and their effects on banks and financial stability", Economic Commentary, March, Sveriges Riksbank.

[20] See Financial Stability Report 2022:1.

[21] Greenhouse gas emissions are measured in different ways. Scope 1 includes direct emissions, scope 2 indirect emissions and scope 3 is indirect emissions not included in scope 2. For a fund management company, for example, scope 3 means emissions related to the companies in which the fund invests.

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APPENDIX – Banks’ risk disclosure requirements

The Basel Committee undertook a major revision of Pillar 3 to address transparency problems that were uncovered during the 2008 global financial crisis. Pillar 3 requires banks to publish information about their own operations. They must do so to enable potential counterparties to better assess their financial position and risk-taking. The revision of Pillar 3 was finalised at the end of 2018 and will be implemented from 1 January 2023.

Pillar 3 - disclosure requirements on banks' capital and risks

Work on revising Pillar 3 began after the global financial crisis and was carried out in three stages. The first stage involved a fundamental change and update of the previous disclosure requirements from 2004 and 2009. One problem raised early on by investors and other stakeholders was that information on Pillar 3 was difficult to find and lacked clear definitions. It was not possible to compare banks or countries with each other or to understand the broader picture of risk. A revision of Pillar 3 was therefore necessary.

In January 2015, the first part of the revision was published. The new transparency requirements follow five guiding principles. This means that banks' risk disclosures shall be

(1) clear
(2) comprehensive
(3) useful
(4) consistent
(5) comparable.[22]

The new Pillar 3 framework is based on harmonised and standardised disclosure requirements with reporting templates and clear definitions. An important aspect in the development of the new requirements by the Committee was that the information should be comparable across banks and countries, while being easily accessible. As a first step, the disclosure requirements for credit, liquidity and market risk were revised.

The second part of the revision was completed in March 2017, at which point all the different disclosure requirements were consolidated into one standard. For example,

[22] See Pillar 3 framework - Executive Summary (bis.org) for a detailed description of the guiding principles.

Stage 2 introduced new disclosure requirements on loss-absorbing capacity (TLAC) and updated disclosure requirements on operational risks.

The third part was finalised in December 2018 and includes requirements for asset encumbrance, leverage ratio and new floor rules for risk-weighted assets. The European Banking Authority is currently working on introducing the final parts of Pillar 3 into European legislation.

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