Risk Accounting Standards Board's response

To the EBA Consultation Paper on

"Draft Implementing Technical Standards on IT solutions for public disclosures by institutions, other than small and non-complex institutions, of the information referred to in Titles II and III of Part Eight of Regulation (EU) No 575/2013"

EBA/CP/2024/20 - 11/10/2024

Contents

Executive Summary

The Risk Accounting Standards Board (RASB) is pleased to offer insights on enhancing the EBA's Pillar 3 Data Hub framework.

Based on our experience, especially in addressing BCBS 239 requirements, we recommend the risk accounting method as a valuable enhancement to current regulatory approaches. By using a unified, additive metric - the Risk Unit (RU) - this method can improve regulatory outcomes through real-time integration of risk and financial data.

Background and Rationale

We strongly believe that effective regulatory frameworks should focus on delivering business benefits to regulated institutions rather than relying on compulsion alone.

When compliance yields clear and measurable business advantages - such as improved efficiency, enhanced market trust, reduced losses or strengthened financial stability - institutions are more likely to embed these practices within their core processes.

Key Contributions:

1. **Transition from Cyclical to Real-Time Reporting**:

    - **Current State**: Present regulatory frameworks, including those supported by the EBA, rely heavily on periodic reporting cycles that limit real-time insights into risk accumulation.

    - **Potential Risk Accounting Contribution**: Our method enables continuous risk assessment by linking financial transactions to quantifiable risk metrics (RUs), allowing for real-time updates and proactive management.

      This integration helps institutions adapt swiftly to changing risk conditions, ensuring that data remains relevant and actionable.

2. **Bridging Risk and Financial Reporting**:

    - **Enhanced Data Cohesion**: By embedding risk data directly within financial reporting, risk accounting creates a consistent and transparent risk profile that will be easy to grasp by decision makers of both regulators and businesses.

      This holistic view supports both internal decision-making and external regulatory reporting, fostering trust and compliance.

    - **Long-Term Impact**: The seamless integration of risk and financial reporting using risk accounting encourages prudent behavior across the institution.

      This method facilitates a proactive risk management culture where strategic decisions are informed by comprehensive, real-time risk insights.

Addressing Potential Challenges:

Our analysis of BCBS 239 implementation revealed persistent challenges, including IT infrastructure constraints and a lack of standardized metrics. The proposed ITS could encounter similar obstacles without clear guidance on adopting unified metrics and best practices. Risk accounting bridges this gap by offering:

- **Unified Metrics**: The RU standardizes risk measurement, ensuring consistent aggregation and reporting across the financial institution.
- **IT Integration Guidance**: While aligning with current IT capabilities, risk accounting supports phased enhancements to embed real-time data processing without overwhelming existing systems.

Recommendations:

- **Open, Collaborative Discussion**: RASB recommends engaging with stakeholders to ensure a clear understanding of the benefits of unifying risk and financial reporting using a consistent metric and to determine the most effective implementation strategy.
- **Pilot Programs**: We recommend pilot implementations of risk accounting within select institutions to demonstrate its practical benefits and address challenges in a controlled environment.
- **Regulatory Support**: RASB is open to working with the EBA and any additional partners on finding ways to incorporate risk accounting as a recognized best practice into future regulation, promoting seamless integration of risk and financial reporting.
- **Guidelines for IT Adaptation**: Detailed guidance on IT infrastructure enhancements will support institutions in transitioning smoothly from periodic to real-time reporting.

Although late to this discussion, RASB is confident that our expertise in risk accounting can contribute significantly to the EBA's efforts. By facilitating real-time reporting and bridging the gap between risk and financial reporting, our approach aligns with the EBA's goals of improved transparency, proactive risk management, and enhanced market discipline.

Adopting risk accounting has the potential to both help meet regulatory objectives as well as encourage the embedding of a risk-aware decision-making culture, reinforcing the stability and resilience of financial institutions in the long run.

Regulation that Works: Benefits Over Compulsion

It is our firm belief that effective regulatory frameworks should prioritize fostering business benefits for regulated parties instead of relying solely on compulsion. When compliance brings tangible business advantages, such as operational efficiency, market trust, or financial stability, institutions are more inclined to integrate these practices into their core processes.

Compulsion, on the other hand, often breeds evasive behavior and minimal adherence, as institutions prioritize meeting the letter of the law over true engagement. This results in fragmented implementations and a failure to achieve the risk mitigation and data integrity outcomes intended by the regulator.

Compulsory measures can prompt regulated parties to adopt superficial compliance strategies, driven by cost minimization rather than a genuine commitment to sound risk management.

This dynamic was especially evident in the case of BCBS 239[1]. Introduced in 2013 and intended to be implemented by 2016 within the ranks of systemically important banks, these requirements were met with reluctance and reactive adjustments, leading to incomplete implementations and inconsistent risk data aggregation.

A regulatory approach that emphasizes mutual benefits, such as improved risk management insights that would result into increased profits by loss reduction, stronger governance, and enhanced market competitiveness, can drive genuine adherence and foster a proactive risk management approach and sustainable compliance culture.

Similarities Between EU Regulation 575/2013, BCBS 239, and the Proposed Regulation in the Consultation Paper

Our analysis indicates that the consultation paper aligns closely with EU Regulation 575/2013 and BCBS 239 in its focus on enhancing transparency, data aggregation, and governance structures.

However, we are of the opinion that without more specific guidance, the regulation proposed in the consultation paper risks repeating the implementation challenges observed with BCBS 239, such as IT constraints, fragmented governance, and superficial compliance efforts.

Below are the key similarities, the most frequent challenges faced by BCBS239 and our recommendations to help avoid the same outcome:

Risk Data Aggregation and Reporting:

- **EU Regulation 575/2013**: Emphasizes the importance of comprehensive data aggregation and consistent reporting to provide a transparent view of an institution's risk profile.
- **BCBS 239**: Establishes principles to improve risk data aggregation capabilities and reporting practices to ensure that risk data is reliable, timely, and comprehensive.

[1] The latest Progress Report in adopting the principles for effective risk data aggregation and risk reporting on the BIS website (available here).

- **Consultation Paper**: Proposes enhancements in risk data aggregation and public disclosures, echoing the need for accurate, reliable, and transparent reporting to facilitate market discipline.

Governance and Internal Controls:

- **EU Regulation 575/2013**: Mandates strong governance structures to oversee risk data processes, ensuring data quality and alignment with regulatory requirements.
- **BCBS 239**: Includes specific principles that require strong governance frameworks for risk data, emphasizing board and senior management responsibility in overseeing risk data aggregation.
- **Consultation Paper**: Highlights the importance of governance frameworks that support comprehensive risk data management, ensuring compliance and quality control.

Transparency and Public Disclosures:

- **EU Regulation 575/2013**: Enforces detailed disclosure requirements to ensure stakeholders can access vital information about an institution's risk exposures and management practices.
- **BCBS 239**: Stresses that comprehensive and understandable risk data should be accessible to stakeholders to promote market confidence.
- **Consultation Paper**: Aims to improve the clarity and comprehensiveness of disclosures to meet the growing demand for transparency and informed decision-making by market participants.

Challenges in the Implementation of BCBS 239 and Potential Recurrence

IT and Data Infrastructure Limitations:

- **BCBS 239 Challenge**: One of the most critical challenges in implementing BCBS 239 was considered the modernizing legacy IT systems and integrating disparate data silos. Banks struggled with the complexity of overhauling IT infrastructure to meet the high standards of risk data aggregation and reporting, resulting in partial or delayed compliance.
- **Potential Recurrence**: The consultation paper may face similar challenges if institutions do not receive clear guidance on how to modernize their systems effectively. Without standardized recommendations, banks could resort to patchwork solutions that fail to achieve the intended level of integration and data quality.

Absence of a Standardized Metric:

- **BCBS 239 Challenge**: The regulation did not mandate a common metric for measuring risk, leading to inconsistent data aggregation practices across institutions. This made it difficult to achieve uniformity in risk reporting.
- **Potential Recurrence**: If the proposed regulations in the consultation paper do not include a requirement for a standardized metric, similar issues may arise. The use of diverse and non-comparable metrics can impede the consistency and comparability of risk disclosures across institutions. Adopting solutions like the *Risk Unit (RU)* proposed by Grody and Hughes[2]

[2] The details can be found in the research paper "Risk Accounting: The risk data aggregation and risk reporting (BCBS 239) foundation of enterprise risk management (ERM) and risk governance" – Part 1 and Part 2 (published in 2016 in the Journal of Risk Management for Financial Institutions and available here)

could mitigate this issue by providing a standardized measure for risk aggregation.

Fragmented Governance Structures:

- **BCBS 239 Challenge**: Institutions often faced difficulties implementing effective governance structures capable of overseeing comprehensive risk data aggregation and reporting. This was due to the lack of clear, enforceable standards and guidance.

- **Potential Recurrence**: The consultation paper's requirements may encounter similar challenges if there is insufficient specificity on how governance frameworks should be structured. Without clear regulatory expectations, institutions may implement minimal or ineffective governance practices, reducing the efficacy of the regulation.

Compliance Driven by Compulsion, Not Incentive:

- **BCBS 239 Challenge**: Many institutions approached BCBS 239 compliance reactively, driven by regulatory pressure rather than understanding its strategic value. This led to superficial compliance efforts focused on meeting minimum requirements.

- **Potential Recurrence**: The consultation paper risks the same outcome if the regulation does not emphasize the business benefits of robust risk data management and transparency. Regulations should advocate for an approach that aligns regulatory goals with business incentives, promoting genuine adoption.

How Specific Guidance Can Prevent Recurrence of These Challenges

Standardized Metrics and Tools:

- Providing clear guidelines for the use of common, standardized metrics like the RU can ensure consistency in data aggregation and reporting. This would address the inconsistencies seen in BCBS 239 implementation and promote comprehensive risk data management.

Detailed IT and Data Management Frameworks:

- The consultation paper should offer more detailed instructions on IT infrastructure requirements, including examples of best practices or phased approaches for upgrading legacy systems. This can prevent the recurrence of incomplete or piecemeal IT implementations.

Enhanced Governance Guidance:

- Clearer mandates for the design of governance structures, including the roles and responsibilities of board members and senior management, can foster more effective oversight of risk data processes. Hughes emphasizes that embedding risk oversight within existing financial systems and controls can ensure robust data governance.

Emphasizing Business Benefits:

- The regulation should stress the long-term advantages of thorough compliance, such as improved decision-making, strategic risk management, and enhanced market trust. Encouraging institutions to view compliance as a competitive advantage rather than a regulatory burden can drive better engagement.

In the interest of fostering meaningful adoption, we believe that the proposed regulation should provide detailed, practical guidance and promote approaches based on risk exposure quantification and integration of risk and financial reporting, which incorporate standardized metrics and integrate risk data management seamlessly with financial processes.

Response to the Consultative Paper's Questions

Question 1 - Do you agree with the proposed IT solutions that would support the implementation of the P3DH to Large and Other institutions? If not, please explain the reasons why.

Comment Relating to IT Solutions:

- **Specific Point**: The proposed IT solutions supporting the implementation of the P3DH for large and other institutions.

- **Response**: While the IT solutions outlined in the consultation paper align with the EBA's objectives of enhancing data aggregation and reporting capabilities across large and other institutions, we believe there are areas where these solutions could be further refined to ensure long-term resilience, scalability, and comprehensive compliance.

  Specifically, there are several considerations and potential enhancements that could improve the effectiveness of the Pillar 3 Data Hub (P3DH) in achieving its objectives.

Key Areas for Improvement and Specific Considerations

1. **Real-Time Data Integration and Processing Capabilities**:

   - **Current Proposal**: The proposed IT solutions focus on periodic data submission in standardized formats, such as XBRL-csv for quantitative data and PDF for qualitative information.

     While these formats enable efficient data aggregation and comparability, they may limit institutions' ability to provide real-time updates or continuous monitoring.

   - **Suggested Enhancement**: Introducing real-time or near-real-time data integration capabilities would allow institutions to submit data continuously, capturing risk exposures as they develop. This could involve enhancing IT infrastructure to support continuous data pipelines or enabling automated updates at shorter intervals.

     Real-time integration would significantly improve the responsiveness of the P3DH, allowing regulators and stakeholders to monitor risk profiles dynamically, especially in volatile market conditions.

2. **Scalability and Flexibility in IT Systems**:

   - **Current Proposal**: The IT solutions appear tailored to handle the current data requirements and reporting volumes.

     However, as the financial landscape evolves and new data requirements arise (such as those related to environmental, social, and governance (ESG) factors), the P3DH's IT framework may require adaptability to scale up or incorporate new data categories.

   - **Suggested Enhancement**: Building scalability and flexibility into the P3DH from the outset will be essential for long-term compliance and resilience.

This could involve designing modular IT systems that can easily integrate additional data sources or metrics without requiring a full system overhaul. For example, implementing a cloud-based or hybrid architecture could allow for the scaling of data storage and processing capacity as needed, avoiding potential system bottlenecks.

3. **Unified Data and Risk Metrics**:

    - **Current Proposal**: The consultation paper mandates standardized formats for data submissions but does not introduce a unified risk metric.

      Without a standardized metric, institutions may face challenges in achieving true comparability across various types of risk exposures, particularly when integrating both financial and non-financial risk data.

    - **Suggested Enhancement**: The introduction of a common metric, such as the *Risk Unit (RU)* proposed by the Risk Accounting Standards Board (RASB), would help unify risk data and allow for consistent aggregation across diverse risk categories.

      Using a metric like the RU, which is additive and scalable, would enable institutions to represent their risk exposure more consistently, improving both internal risk management and external comparability.

4. **Long-Term IT Infrastructure Upgrades and Interoperability**:

    - **Current Proposal**: The IT solutions focus on ensuring that institutions can submit data in a standardized format to the P3DH.

      However, many institutions, especially larger ones, operate on complex legacy IT infrastructures that may struggle with interoperability and integration.

    - **Suggested Enhancement**: A phased approach to IT infrastructure upgrades could be encouraged, allowing institutions to gradually integrate systems capable of handling real-time and cross-functional data requirements.

      For instance, the EBA could provide a roadmap for aligning legacy systems with new standards, supported by technical guidelines on how to achieve interoperability between older systems and the P3DH.

Rationale and Evidence:

- **Rationale**: The proposed reliance on upgrading existing IT systems to meet the P3DH's data requirements, without fundamentally transforming the underlying data structure, risks perpetuating some of the key implementation issues observed during BCBS 239.

  Specifically, BCBS 239's implementation highlighted the persistent challenges of fragmented data silos, limited interoperability between legacy systems, and insufficient real-time data integration—all of which could hinder the EBA's objectives for the P3DH.

Grody and Hughes' research in risk accounting underscores the importance of a unified, foundational approach to data management. Their work emphasizes that sustainable improvements in risk reporting and management cannot be achieved solely by layering new requirements or formats onto existing IT systems. Instead, the introduction of a standardized, additive metric, such as the *Risk Unit (RU)*, embedded within a unified data structure, is crucial for achieving a truly integrated risk management system. This unified data approach would allow for seamless data aggregation, improved interoperability, and real-time reporting—three critical aspects that align closely with the EBA's goals for the P3DH.

Challenges from BCBS 239 and Their Relevance to the P3DH Implementation

During BCBS 239 implementation, financial institutions encountered significant barriers due to their reliance on existing IT architectures. Key issues included:

1. **Data Silos and Fragmented Systems**:
    - Many institutions struggled with compartmentalized data systems that prevented holistic risk data aggregation. These data silos led to inconsistencies, delayed reporting, and inefficiencies in consolidating risk information across the enterprise.
    - **Relevance for P3DH**: Without a foundational shift towards a unified data structure, the P3DH implementation could face similar fragmentation, where risk data remains confined within departmental silos or incompatible IT systems. This would undermine the benefits of centralized, standardized reporting and hinder the EBA's ability to achieve comprehensive risk visibility across institutions.
2. **Integration Complexities**:
    - Legacy IT systems often lacked the ability to interact smoothly with newer technologies or regulatory platforms, creating a disjointed reporting environment. BCBS 239 aimed to foster consistent and reliable risk reporting, yet institutions found it difficult to reconcile diverse systems and data sources without substantial IT restructuring.
    - **Relevance for P3DH**: Relying solely on incremental IT upgrades for the P3DH could similarly limit integration effectiveness. Real-time data aggregation and consistency in reporting will require more than technical upgrades; they demand a harmonized, interoperable data structure that allows for continuous, automated data flows across the organization.
3. **Inconsistent Data Models and Metrics**:
    - BCBS 239 lacked a standardized, additive metric for quantifying and reporting risk, leading to inconsistencies in how institutions measured and disclosed risk. This variability complicated the regulatory oversight process, limiting the comparability of data across institutions.
    - **Relevance for P3DH**: The lack of a unified risk metric in the current IT solutions could result in inconsistent data reporting, potentially compromising the EBA's objectives for comparability and transparency. A standardized metric like the RU would enable

institutions to report risk data that is additive and comparable, reducing discrepancies and providing regulators with a clearer, more unified picture of risk across the sector.

Proposed Enhancements to Avoid Repeating BCBS 239 Challenges

To avoid repeating these challenges in the P3DH implementation, the EBA should consider incorporating the following enhancements into the regulatory guidance:

1. **Unified Data Structure with Embedded Risk Metrics**:
    - Establishing a foundational, unified data structure that integrates risk and financial reporting will facilitate data consistency and enable real-time insights. Using a standardized metric such as the RU would provide an additive, scalable approach to quantify risk, allowing institutions to aggregate risk data seamlessly across departments and systems.
2. **Encouragement of Phased IT Restructuring**:
    - Instead of relying on patchwork upgrades to existing IT systems, the EBA could encourage a phased, strategic IT restructuring plan for institutions.

      This would include the gradual adoption of modern, interoperable systems that can natively support real-time data integration and reporting. Such an approach aligns with Grody and Hughes' emphasis on long-term structural improvements rather than short-term fixes.

- **Evidence**: In his book *Risk Accounting*[3], Peter Hughes, RASB's founder, argues that effective risk management and reporting require the integration of financial and non-financial risk data using standardized, additive metrics, such as *Risk Units (RUs)*.

  This approach is designed to overcome the limitations of fragmented data systems and disparate risk metrics, which have historically hindered comprehensive and consistent risk aggregation.

  Hughes emphasizes that without a unified, standardized metric, financial institutions are left with data inconsistencies and misalignments between different risk categories, making it difficult to obtain an accurate, real-time picture of overall risk exposure.

Key Points from *Risk Accounting* Supporting the Use of RUs:

- **Additive and Scalable Nature of RUs**:
    - Hughes explains that RUs are inherently additive, meaning they can be aggregated across different departments, risk types, and reporting periods. This characteristic is crucial for institutions that need to consolidate diverse risk exposures into a unified, interpretable measure for both internal decision-making and regulatory reporting.
    - **Implication for P3DH**: With RUs, institutions could create a single, comprehensive metric for risk that aligns with the EBA's goals of consistent and comparable reporting. This additive quality also

[3] The "Risk Accounting" book by Peter J. Hughes is available for purchase on Amazon and other retailers.

simplifies reporting structures, reducing the need for complex data reconciliation across risk categories.

- **Real-Time Integration and Monitoring**:
  - Hughes' risk accounting method embeds RUs directly within financial reporting, allowing institutions to track risk accumulation on a real-time basis rather than waiting for periodic reporting cycles. By linking every financial transaction to a quantifiable RU, institutions can monitor risk as it develops.
  - **Implication for P3DH**: The EBA's P3DH could benefit from this continuous data flow, enabling real-time updates in risk profiles rather than relying on static snapshots. Real-time integration not only improves regulatory oversight but also empowers institutions to act proactively, adjusting risk strategies in response to emerging threats.
- **Reduction of Data Silos and System Discrepancies**:
  - *Risk Accounting* stresses the importance of a unified data structure to overcome the challenges posed by legacy systems and siloed data sources. By using RUs, risk accounting unifies disparate risk data, reducing dependency on complex data integration projects and minimizing errors associated with reconciling multiple data systems.
  - **Implication for P3DH**: The EBA's objective to centralize risk data through the P3DH is directly supported by the risk accounting approach. RUs eliminate the fragmentation between financial and non-financial risk data, making data submission and aggregation to a centralized hub more streamlined and reducing the risk of inconsistencies.
- **Improved Comparability Across Institutions**:
  - Hughes highlights that a standardized metric like the RU can serve as a universal measure of risk, allowing comparisons between institutions regardless of their size or business model.

    RUs provide a common language for risk, which enhances transparency and comparability, a key requirement in regulatory frameworks like BCBS 239 and P3DH.
  - **Implication for P3DH**: By encouraging the adoption of RUs, the EBA could significantly improve the comparability of risk data across institutions, enhancing the value of centralized reporting for both regulators and stakeholders.

    This comparability supports more meaningful sector-wide analyses and fosters a level playing field.
- **Support for Proactive and Prudent Risk Management**:
  - According to Hughes, the ability to integrate risk data directly into financial processes promotes prudent behavior and proactive risk management.

    By having a clear, quantitative view of how risk accumulates in real-time, institutions are better equipped to make informed decisions that align with their overall risk tolerance and regulatory requirements.

  - **Implication for P3DH**: Embedding this proactive approach into the P3DH would encourage institutions to manage risk continuously, rather than treating risk management as a reactive compliance exercise.

    This aligns with the EBA's long-term vision of fostering stability and resilience in the financial sector.

Alternative Regulatory Choice:

- The EBA could consider mandating the adoption of a framework similar to *Risk Accounting* that embeds a dedicated risk quantification metric into financial systems.

  This would create a seamless, robust infrastructure for risk data that aligns with P3DH requirements while preventing common data integration issues.

Question 2 - Would you agree with the specification to provide the information on remuneration policies separately? If not, please explain the reasons why.

Comment Relating to Remuneration Policies:

- **Specific Point**: The specification to provide information on remuneration policies separately.
- **Response**: We agree with the proposal, provided that the reporting format ensures transparency and aligns with risk and financial data.

Rationale and Evidence:

- **Rationale**: Disclosing remuneration policies separately enhances clarity and allows stakeholders to evaluate potential incentive-related risk behavior. However, in his research, Peter Hughes generally emphasizes that transparency alone is not sufficient without integrating such data into broader risk reporting.

  Remuneration data should be evaluated in the context of the overall risk profile to provide a full picture of potential vulnerabilities.

- **Evidence**: In the context of *Risk Accounting*, remuneration metrics can be tagged with RUs within the conduct risk context, to correlate compensation practices with risk exposure, enhancing the understanding of how incentives may affect risk behavior.

Alternative Regulatory Choice:

- In our view, the EBA could integrate the use of standardized metrics, like RUs, for aligning remuneration disclosures with risk data aggregation, facilitating more meaningful risk assessments.

  The RASB expresses its availability to work together with the EBA, government and industry stakeholders to research and codify the best way for this initiative to be implemented.

Question 3 - Would you agree with the proposal on the collection of contact points information, including the suggested monthly frequency?

Comment Relating to Contact Points Collection:

- **Specific Point**: The collection of contact points information and the proposed monthly frequency.

- **Response**: We agree with the collection of contact points information but have reservations about the proposed monthly frequency.

Rationale and Evidence:

- **Rationale**: Monthly updates may not provide significant incremental benefits over quarterly updates, which would be more practical and reduce administrative burdens. The focus should be on ensuring that contact persons are equipped with comprehensive knowledge about data aggregation and reporting processes.

- **Evidence**: Hughes' emphasis on governance suggests that while frequent updates can support dynamic oversight, the true effectiveness lies in ensuring contact points have in-depth training and a clear understanding of risk reporting systems.

Alternative Regulatory Choice:

- Consider quarterly updates with mandated training sessions to maintain readiness and reliability of contact points' knowledge and oversight capabilities.

Question 4 - Would you have any comments or suggestions on the most adequate profile of the contact persons within the institution?

Comment Relating to the Profile of Contact Persons:

- **Specific Point**: Adequate profile for contact persons within institutions.

- **Response**: We recommend that contact persons possess a strong background in integrated risk management and data governance.

Rationale and Evidence:

- **Rationale**: Contact persons should not only be compliance experts but also have in-depth knowledge of financial and risk data integration practices, such as those in *Risk Accounting*. This ensures they can oversee data quality and the application of unified risk metrics.

- **Evidence**: Hughes' and Grody's work emphasizes that proper implementation of frameworks like BCBS 239 and P3DH relies on knowledgeable personnel who understand the complexities of aggregating risk data across business lines.

Alternative Regulatory Choice:

- The EBA should specify that contact persons should have qualifications or training in integrated risk and data management, emphasizing practical expertise with standardized data systems.

Final Recommendations:

In our view, integrating insights from *Risk Accounting* and research by Grody and Hughes provides a clearer pathway for the P3DH's successful implementation. Leveraging these concepts can address both data aggregation and governance issues effectively, ensuring that regulatory compliance adds strategic value to institutions and fosters a deeper culture of risk awareness.

Enhancing Regulatory Outcomes and Transitioning to Real-Time Reporting

The implementation of standardized and advanced measurement approaches under the current regulatory framework has significantly improved the ability of financial institutions to quantify and report operational risk. However, these methods largely focus on periodic, cyclical, effort-intensive reporting that may not provide timely insight into risk accumulation.

The risk accounting method introduces innovative concepts that could substantially enhance the desired regulatory outcomes, allowing for a transition from traditional cyclical reporting to real-time risk monitoring.

This section further explores how adopting risk accounting can provide these long-term improvements and facilitate deeper integration of risk and financial reporting.

Transition from Cyclical to Real-Time Reporting

- **Current State**: Present regulatory requirements, including those under the EBA's guidance and CRR, typically mandate periodic reporting cycles (e.g., quarterly or annually).

  While comprehensive, these reports may not capture sudden changes in an institution's risk profile, as they occur, or provide dynamic and timely data on risk exposure accumulations to allow for rapid decision-making.

- **Potential Contribution of Risk Accounting**: The risk accounting method allows for real-time reporting by embedding quantitative risk data directly within the financial reporting structure using *Risk Units (RUs)*. By linking every transaction or operational decision to a quantifiable risk metric, institutions can maintain a continuous, dynamic and integrated view of risk as it accumulates. This capability bridges the gap between traditional reporting cycles and the need for dynamic, proactive risk management.

Direct Integration with Financial Reporting

- **Unified Metrics**: One of the most powerful features of the risk accounting method is its use of RUs, which serve as a standardized, additive metric for measuring risk. These units can be aligned with financial transactions and activities, creating a seamless integration between financial and risk reporting.

- **Enhanced Transparency and Consistency**: By embedding risk data within financial reporting, risk accounting promotes a consistent view of risk that aligns operational exposures with financial performance. This alignment ensures that risk is no longer monitored as a separate function but becomes an inherent part of financial decision-making, enhancing transparency for regulators and stakeholders.

Long-Term Benefits of Adopting Risk Accounting

- **Improved Risk Visibility**: The real-time nature of risk accounting provides financial institutions with immediate insights into their risk exposure, allowing them to respond promptly to emerging risks. This capability is especially important in a rapidly changing financial environment where delayed reporting could lead to significant vulnerabilities.

- **Proactive Risk Management**: Continuous reporting enables institutions to move from a reactive to a proactive risk management approach. The direct link between operational activities and risk metrics allows management to adjust strategies and operations to mitigate risks before they escalate.

- **Regulatory Confidence**: For regulatory bodies, the adoption of risk accounting would mean access to more timely and accurate data. This improves their oversight capabilities, ensuring that they can identify systemic risk accumulations early and enforce more effective safeguards.

  Moreover, standardization will allow direct comparability among institutions, therefore reducing regulatory workload.

Addressing Limitations of Current Reporting Approaches

- **Operational Challenges in Cyclical Reporting**: Current regulatory frameworks, including those informed by the standardized and advanced measurement approaches, rely heavily on retrospective data. This can limit their effectiveness in rapidly changing market conditions where risk profiles can shift between reporting periods.

- **Enhanced Data Integration**: Risk accounting can address these limitations by embedding risk data into financial processes, allowing institutions to provide continuous updates on risk exposure as part of routine financial reporting. This reduces reliance on extensive data aggregation and verification steps traditionally associated with cyclical reporting.

Bridging the Gap Between Regulation and Practice

- **Supporting Compliance and Innovation**: The integration of risk accounting supports regulatory goals of transparency and comprehensive risk oversight, as seen in the EBA's Pillar 3 disclosures. It aligns with ongoing efforts to enhance comparability and usability of data but takes it a step further by automating the integration of risk metrics with financial data.

- **Practical Implementation**: To make this transition, regulators could start by encouraging pilot programs where financial institutions adopt risk accounting for specific business units. This phased approach allows for the gradual integration of risk accounting into larger financial frameworks, demonstrating its value and addressing potential implementation challenges.

- **Regulatory Adjustments**: The EBA and other regulators could provide guidelines for transitioning to real-time reporting. This could include requirements for embedding standardized risk metrics like RUs and establishing IT infrastructure capable of supporting integrated financial and risk data.

Future Outlook and Recommendations

- **Reduced Operational Delays**: By fostering an environment where risk and financial data coexist in real-time, institutions can minimize operational delays in risk detection and reporting. This leads to a more agile financial system, capable of adapting to shocks and stresses more effectively.

- **Encouragement of Best Practices**: Regulators should consider recognizing risk accounting practices as part of their compliance frameworks, promoting them as a best practice for advanced risk management and real-time reporting.

- **Technological Investment**: To enable this transition, institutions may need to upgrade their IT systems to support real-time data collection and analysis.

Regulatory support in the form of phased guidelines and technical standards could ease this transition and encourage wider adoption.

Adopting the risk accounting method as an extension of current regulatory practices could dramatically enhance the effectiveness of risk reporting. By transitioning from cyclical, periodic reporting to a real-time, integrated model, institutions would gain the ability to monitor and manage risk more dynamically.

This would not only improve compliance with existing regulations but also future proof the risk management strategies of financial institutions, ultimately fostering a more transparent, stable, and resilient financial system.