European Commission

Study prepared by PwC for European Commission DG Markt following the contract 2014/S 102-177729

General assessment of potential economic consequences of country-by-country reporting under CRD IV

Executive Summary

September 2014

Following an open call for tenders (Ref MARKT/2013/205/F), the Internal Market and Services Directorate General (DG MARKT) has commissioned PwC to undertake a general assessment of potential economic consequences of country-by-country reporting under CRD IV, including an econometric study of the impact of disclosure quality on capital market outcomes and a number of other key outcomes. DG MARKT is the addressee of this report.

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Executive summary

Introduction of Article 89 to CRD IV

In February 2013, the European Parliament proposed the inclusion in CRD IV of a requirement for credit institutions and investment firms to publish annually the following tax and financial data for each country in which they operate:

a) name(s), nature of activities and geographical location
b) turnover
c) number of employees on a full time equivalent basis
d) profit or loss before tax
e) tax on profit or loss, and
f) public subsidies received.

Following the agreement of the co-legislators this requirement became Article 89 of CRD IV and will apply in full from 1 January 2015.

Perhaps owing to being introduced late in the legislative process, the CBCR requirements contain little detail and leave many points open to different interpretations. This has been a recurring theme throughout our work.

Only GSIBs are required by Article 89 to report items a) to f) by 1 July 2014, with items d) to f) being privately disclosed to the European Commission and items a) to c) being publically disclosed.

All other institutions are only required to make full disclosure of all six items from 2015, but must publically disclose items a) to c) by 1 July 2014.

The fourteen GSIBs[1] that were required to report to the Commission by 1 July 2014 are:

a) Barclays
b) BNP Paribas
c) BBVA
d) Deutsche Bank
e) Groupe BPCE
f) Group Credit Agricole
g) HSBC
h) ING Bank
i) Nordea
j) Royal Bank of Scotland
k) Santander
l) Societe Generale
m) Standard Chartered
n) Unicredit

[1] FSB update of group of global systematically important banks, 1 November 2012

Requirement to prepare an assessment of Article 89

Paragraph 3 of Article 89 requires that "the Commission, after consulting EBA, EIOPA and ESMA, as appropriate, shall conduct a general assessment as regards potential negative economic consequences of the public disclosure of such information, including the impact on competitiveness, investment and credit availability and the stability of the financial system. The Commission shall submit its report to the European Parliament and to the Council by 31 December 2014."

Our work was requested by the Commission, following an open call for tenders (Ref MARKT/2013/205/F), to assist it in preparing its report to the Parliament and to Council. The scope of this work was agreed with the Commission as set out in our contract number MARKT/2013/205/F2/ST/OP. The contract includes the terms of reference from the related invitation to tender and from our response to that tender.

Our work covers the following areas:

- an academic literature review and econometric study to investigate potential links between financial reporting disclosures and a set of economic outcomes for reporting institutions;
- a survey of a range of stakeholders including civil society organisations, governments, regulators, banks and trade associations to obtain their views on likely economic impacts;
- a survey of PwC experts to determine how Article 89 has been implemented in the 28 EU Member States; and
- a review of the first disclosures by GSIBs made under Article 89.

The work that we have agreed to perform seeks to address not only the remit for assessment as set out in Article 89 (3), but also considers whether the Article 89 disclosures will meet the objective of restoring public trust in the financial services sector as set out in recital (52) to CRD IV, namely:

"Increased transparency regarding the activities of institutions, and in particular regarding profits made, taxes paid and subsidies received, is essential for regaining the trust of citizens of the Union in the financial sector. Mandatory reporting in that area can therefore be seen as an important element of the corporate responsibility of institutions towards stakeholders and society".

Overview of the work performed

The scope of our work was agreed with DG MARKT as set out in our contract number MARKT/2013/205/F2/ST/OP. The contract includes the terms of reference from the related invitation to tender and from our response to that tender.

The principal objective of our work, as stated in 3.2.1 of the invitation to tender, was to carry out a general study on potential economic consequences, both positive and negative, of the public disclosure of information such as the information referred to in Article 89(1) CRD IV with a specific focus on the impact on competitiveness, investment and credit availability and the stability of the financial system. The study was designed with the intention of covering all institutions subject to the reporting requirement and also sought the views of other stakeholders that have an interest in the regime, although they are not subject to it.

The work to be performed as well as the detailed methodologies were discussed and agreed with DG MARKT at various stages in our work.

In line with the contract we used a number of methods to investigate the potential economic impact of the country-by-country reporting (CBCR) requirements contained within Article 89 of the EU Capital Requirements Directive IV (CRD IV). We carried out the following:

- econometric study - an academic literature review and based on the literature we developed a consistent methodology to quantify banks' disclosure quality and conducted an econometric analysis to investigate potential links between disclosure quality and economic impacts for the reporting institutions
- stakeholder survey - a survey of a range of stakeholders including civil society organisations (CSOs), governments, regulators, banks and trade associations to obtain their views on likely economic impacts
- legal implementation analysis - a survey of PwC experts to determine how Article 89 has been implemented in the 28 EU Member States
- review of disclosures - a review of the first disclosures made under Article 89 by twelve of the fourteen EU-headquartered globally systemically important banks (GSIBs) that were required to report to the European Commission by 1 July 2014

Within our response to the invitation to tender we contemplated carrying out economic modelling to look at the economic effect should CBCR be thought likely to increase the effective corporate income tax rates of financial institutions. In the course of our work it became apparent that the assumptions required for such modelling would be very broad and so it was agreed with the Commission to exclude this from the scope of our work.

Conclusions

It is very early to form a view on the impact of the provisions of Article 89 of CRD IV. However, on the basis of the views that we have obtained from the organisations that responded to our survey, the balance of opinion suggests that these provisions are likely to have some impact, as intended, in improving the trust of citizens of the European Union in the financial services sector. Specifically, our stakeholder survey suggests that the respondents expect Article 89 to have some positive impact on the transparency and accountability of, and on the public confidence in, the financial services sector in the EU.

Furthermore, the balance of opinion and the work we performed suggest this improvement is likely to be obtained without the public disclosure of such information having noticeable negative economic consequences, including the impact on competitiveness, investment and credit availability and the stability of the financial system.

Looking at each of these impacts in turn:

Competitiveness – Although our econometric study has not captured the impacts on competitiveness directly, our results suggest that improved disclosure quality, which is a key objective of CBCR, could improve firms' competitive outcomes. The analysis suggests that an improvement in disclosure quality is associated with a reduction in earnings management[2], which could have positive impacts on firms' competitiveness.

Furthermore, the stakeholder survey indicated that 53% of respondents felt there would be no impact on competitiveness. The fact that three of the fourteen GSIBs have published their Article 89 disclosures in full in 2014 would suggest that they are not overly concerned that there will be a detrimental effect on their competitiveness. While many stakeholders recognised that there is a compliance cost for firms in complying with Article 89, it was generally felt not to be significant when compared to the overall cost of the wider regulatory compliance burdens faced by the reporting institutions. The compliance cost associated with Article 89 therefore seems unlikely to disadvantage reporting institutions significantly compared to non-reporting institutions.

Credit availability – Our econometric results suggest that CBCR is unlikely to have any negative impact on banks' ability to access capital markets. The improvement in disclosure quality as a result of CBCR could have an impact on reducing banks' cost of equity capital – an improvement in the disclosure score of 1 reduces the cost of equity capital by 0.2 percentage points, and these benefits could be passed onto non-financial sector firms and households in the form of lower lending rates.

This contrasts with the views from the stakeholder survey which indicated that only a very few respondents expect a positive impact on credit availability as a result of Article 89. The vast majority of respondents expected that there would be no impact on credit availability.

Investment – Related to the point on credit availability, our econometric results suggest that CBCR is unlikely to have a negative impact on investment. The improvement in disclosure quality, as perceived by capital markets as a result of CBCR, could lead to a lower cost of equity capital for banks, which may translate into

[2]Earnings management is where a firm's management use accounting discretion in presenting financial results in order to present the entity to investors in an artificially positive light.

lower lending rates and enable firms to invest in their business and expand. However, these impacts are likely to be small.

In terms of investment into reporting institutions, 61% of stakeholders responding to the survey expected no impact on the investment in reporting institutions, 28% expected a positive or very positive impact, with regulators and CSOs generally having a more positive view than businesses.

Stability of the financial system – The evidence from our econometric analysis suggests that an increase in disclosure quality, which is a key objective of CBCR, could have a small but positive impact on accounting quality. This means that following the implementation of CBCR, the information provided by financial institutions could become more informative for external stakeholders, and better reflect the true economic condition of the institution. This could result in lower volatility and increased financial stability.

Three quarters of the stakeholders responding to the survey expected there to be no impact on the stability of the financial services sector, with 18% expecting a positive impact. It was noted that while there may be a negative effect on specific institutions it was felt unlikely that this would significantly affect the sector as a whole.

Although our econometric results provide some insights into the potential impacts of CBCR, we are necessarily inferring from the historical relationships between disclosure quality and the outcomes of interest (i.e. banks' cost of equity capital, bid-ask spread, accuracy of earnings forecasts and the likelihood of earnings management) to draw possible conclusions for CBCR. **Caution is therefore required when interpreting the results and conclusions from our study and their applicability to CBCR**. In particular, it seems likely that the benefits of incremental improved disclosure will decline with successive initiatives, as the pre-existing level of disclosure is already higher. Furthermore, it is impossible to quantify the extent to which CBCR will improve disclosure compared with the historical improvements in disclosure quality which we have observed from our data and which form the basis for our model estimation. Nevertheless, our academic literature review and econometric modelling do suggest that, to the extent that there is an improvement in disclosure resulting from CBCR, then directionally this would be expected to be associated with positive outcomes for the economic performance of the reporting institutions and their customers.

The stakeholder survey and our review of the implementation and interpretation of Article 89 as well as our review of the first disclosures of the GSIBs suggest that the beneficial impact of Article 89 could be improved by addressing a number of the issues that have arisen concerning the implementation and interpretation of Article 89.

Without changes to improve the clarity and consistency of the interpretation of Article 89, and a consequent increase in the comparability of the data disclosed, there appears to be a risk that benefits associated with the disclosure could be undermined.