# Weighing up the risks

***John Hitchins** looks at whether there is a case to be made for risk-weighted assets being included in external audits*

Metro Bank's recent embarrassing announcement of a major adjustment to its calculation of risk-weighted assets (RWAs) has put the spotlight back on an important fact: this critical input to a bank's measure of its capital strength is outside the scope of the external audit. The episode led to a senior regulator, Bill Coen, secretary general of the Basel Committee on Banking Supervision, telling the *Financial Times* that getting external auditors to look at RWAs was "a very interesting prospect".

Should investors be demanding that RWAs be included in future audits? This is not a new question. An Institute of Chartered Accountants in England and Wales (ICAEW) report on potential enhancements to bank audits following the 2008 financial crisis, which I co-authored, recommended that the capital ratio calculation be brought into the scope of the audit.

When an auditor proposes something that would generate more work for auditors, it can appear somewhat self-serving, but investors told us they were more concerned about understanding the movements in RWAs than they were about getting assurance on a point-in-time number. The movement analysis was taken up by the Financial Stability Board's Emerging Issues Task Force recommendations and many banks now publish such an analysis. I believe publication of these analyses increases, rather than deceases, the value of assurance on the opening and closing numbers and, indeed, the ICAEW has recently repeated its recommendation.

Although traditionally considered difficult, it is possible to audit the number, notwithstanding the complexity of the judgments that have to be made in the asset classifications. The issue is whether such an audit would be cost-effective. The figures used in the calculation typically come from bank systems that are not subject to the internal financial reporting control framework that governs the production of financial statements. If there is not an equivalent framework around the RWA data, an auditor cannot apply a controls-based approach and the audit will depend on a lot of (expensive) substantive work.

Most banks today have a proper reporting control framework around the RWA data and an audit requirement would probably force any that still do not to develop one. As UK banks typically report their RWAs in the annual report and accounts, it would be straightforward to extend the audit opinion to cover them. This means the audit could be done under the existing framework of auditing standards. The relative responsibilities of auditor and management would be the same as for the financial statements.

Should management or regulators require an RWA audit anyway, irrespective of investors' views? As an audit committee chairman, I want assurance on the reliability of my bank's capital ratio calculation as much as I do on the financial statements. But I get this from the control framework we have around the data, the results of control self-assessment testing and from internal audit. With a strong internal audit department, I do not feel the need for a further audit unless investors tell us they want it. I think most bank managements would agree with me.

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Regulators similarly want some assurance but are typically happy to acquire this in private. In the UK, the regulators have tended to get assurance from their own periodic inspection visits. Indeed, the errors Metro made appear to have been found by the Prudential Regulation Authority (PRA) rather than the bank itself. Where the regulators have a concern about the way a bank is calculating its RWAs, they have the power to commission a special audit under the S166 regime. Regulators would, no doubt, welcome an external audit as giving them more assurance, but they are unlikely to push for it.

We are back to what investors want but there is one further dynamic. The Brydon Review is examining the scope and purpose of external audit and is considering the extent to which the audit should cover information in the unaudited front half of the annual report. It has no specific bank audit remit, but whatever it concludes is likely to influence the debate over whether RWAs should be audited. ■

***John Hitchins** is a NED specialising in financial services and chairs two audit committees, one at Aldermore Group. He spent 38 years with PwC, specialising in bank audits and regulatory reviews, including 10 years leading its banking industry specialist group*