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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

General assessment of economic consequences of country-by-country disclosure requirements set out in Article 89 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013

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I. Introduction

Directive 2013/36/EU[1] ("CRD") introduces in its Article 89 a new country-by-country public reporting obligation ("CBCR") for banks and investment firms ("institutions"). Institutions will have to report annually, for each country in which they have an establishment, data on (a) their name(s), activities, geographical location, (b) turnover, (c) staff numbers, (d) profit or loss before tax, (e) tax on profit or loss and (f) public subsidies received.

Institutions are required to report the data under a), b) and c) as from 1 July 2014. For the data under d), e) and f) a special arrangement is foreseen: in an initial phase only 14 of the most important European institutions[2] ("EU G-SIIs") had to report these data, on a confidential basis, to the Commission. The deadline for this initial confidential reporting was 1 July 2014 and was respected by all 14 EU G-SIIs. In the next phase, i.e. as from 1 January 2015 all institutions that fall within the scope of Article 89 ("reporting institutions") are required to disclose all information set out in Article 89, unless the Commission decides to defer the CBCR obligations.

Article 89 requires that the Commission report to the European Parliament and to the Council by 31 December 2014 on the potential negative economic consequences of the public disclosure of the country-by-country information. The Commission, after consulting EBA, EIOPA and ESMA, as appropriate, is requested to conduct a general assessment as regards such consequences including the impact on competitiveness, investment and credit availability and the stability of the financial system. Pursuant to Article 89, in the event that significant negative effects are identified, the Commission shall consider proposing to amend the CBCR obligations, and may decide to defer those obligations.

The key objective of this report is thus to provide the Commission's assessment of whether CBCR leads to significant negative economic effects.

The Commission awarded, through an open call for tender[3], a study to an external contractor on the potential positive and negative consequences of CBCR. The study by the external contractor included a stakeholder survey[4] and an econometric analysis ("the econometric analysis")[5]. The

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. OJ L 176, 27.6.2013, p. 338.

[2] The so-called global systematically important institutions authorised within the Union, as identified internationally, Financial Stability Board Update of group of global systemically important banks 1 November 2012; http://www.financialstabilityboard.org/publications/r_121031ac.pdf.

[3] Tender Ref MARKT/2013/205/F.

[4] A range of stakeholders were consulted including civil society organisations, governments, regulators, banks and trade associations.

Commission consulted EBA, EIOPA and ESMA. It also directly consulted with stakeholders, including inter alia the 14 EU G-SIIs[6] and several civil society organisations interested in the matter. The Commission organised a public consultation[7] and an outreach event[8]. All stakeholders were thus given ample opportunity to provide their views. On this basis, the Commission conducted its assessment of the possible economic effects of CBCR.

II. Context

Recital (52) of CRD explains that "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." CBCR will help stakeholders to get a better understanding of groups' structures, their activities and geographical presence. In addition CBCR should help understanding of whether taxes are being paid where the actual business activity takes place. Disclosure and transparency are seen as key regulatory tools which help to ensure that firms effectively implement their obligations and are accountable for the business strategies which they adopt.

The new CBCR obligations must be seen against the background of the recent financial crisis, in which unprecedented levels of public support were necessary in order to restore financial stability and the trust of citizens in the financial sector was heavily affected. This led to strong demands for banks to show greater accountability and increased transparency in their relations with the public.

Independently from the financial crisis, there are increasing calls on companies to take responsibility for their impact on society and the contribution that businesses make in the form of taxation is increasingly seen as part of corporate social responsibility. This has increased demand for more transparency in the tax affairs of large enterprises in particular where they have significant cross-border activities.

III. Assessment of economic effects of CBCR

Most stakeholders expect that CBCR will have some positive impact on the transparency and accountability of, and on public confidence in the European financial sector.[9] Nevertheless, various stakeholder groups consider that additional guidance on the exact contents of the items to be reported would improve transparency and consistency, would alleviate the risks of the data being misunderstood and limit the administrative burden.

[5] The study of the external contractor can be consulted at : http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm

[6] A summary of the consultation with the 14 EU G-SIIs can be consulted at: http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm

[7] The contributions can be consulted at: http://ec.europa.eu/internal_market/consultations/2014/country-by-country-crd4/contributions_en.htm

[8] The outreach event was held on 2 October 2014. The participants represented the different stakeholder groups. A summary of the discussion can be consulted at: http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm#240711

[9] See the summary of discussion at the outreach event, the responses to the public consultation and the report of the external contractor, pages 87, 91, 145-147.

Below the potential economic consequences of CBCR, in particular on competitiveness, investment, credit availability and the stability of the financial system are examined. The findings reflect the feedback received from stakeholders as part of the surveys conducted by the Commission and by the external contractor, the public consultation and the outreach event, as well as the results of the econometric analysis.

A. Impact on competitiveness

The majority of stakeholders consider that there will be no negative impact on the competitiveness of reporting institutions.[10] Nevertheless, some submit that, given the absence of a global level playing field, reporting institutions will be disadvantaged compared to institutions not bound by CBCR because they will face additional administrative burden and cost, because they will be confronted with public scrutiny over their data and because they will need to disclose more specific business information than their non-reporting competitors. These stakeholders, which are a minority, believe that CBCR will have a negative impact on competitiveness, even though they generally do not expect this negative impact to be strong.

Others expect that CBCR will have a positive impact on the competitiveness of reporting institutions. It is suggested that the increased transparency and accountability resulting from CBCR will encourage reporting institutions better to consider a range of risks resulting from their internal organisation and activities. In this way, better transparency would serve not only to reveal possible problems, but also to prevent them. It would thus have the potential of reducing risks from scandals that would be damaging for the institution's reputation and investor and customer trust and can contribute to restoring public confidence in the financial services sector in the EU. They also consider that CBCR can attract investors and customers that value the increased transparency, which in turn can result in competitive advantage for reporting institutions.

The cost for compliance with CBCR is likely to be inherently proportional to the size and multi-national dimension of the business of the reporting institution. Reporting institutions, especially multinational groups, are likely to already have in place sophisticated systems for data collection. The cost of compliance with CBCR is not expected to be significant.[11]

The information disclosed under CBCR does not appear to be commercially confidential. The level of information disclosed under CBCR is not sufficient for interested parties to get a detailed understanding of the commercial strategies of the reporting institutions. At least 3 EU G-SIIs have already voluntarily published CBCR data, seemingly without concerns about revealing commercial confidential information or other competitive effects.

The results of the econometric analysis suggest that an improvement in disclosure quality, which is a key objective of CBCR, is associated with a reduction of the ability of reporting institutions to mask their true performance (earnings management). The study finds that a one point increase in the level of disclosure (in a composite indicator of scale 0-52) decreases the probability of managing earnings by 3.5% for the sample of banks in the study.[12]

[10] See the summary of the discussion at the outreach event, the responses to the public consultation, the summary of the responses to the G-SIIs consultation and the report of the external contractor, page 139.

[11] For more details, see the report of the external contractor, page 97 and the summary of the responses to the G-SIIs consultation.

[12] Report of the external contractor, pages 73-83 and 84-85.

Although the econometric analysis does not capture the impacts on competitiveness directly, a review of the literature suggests that greater levels of disclosure could enable banks to become more competitive (for example because it would reduce the information asymmetry problem, facilitate the allocation of resources and increase trust). Overall the study suggests that CBCR is unlikely to lead to adverse effects on competition.

Some stakeholders expect that the CBCR disclosure obligations will affect the effective tax rate of banks. CBCR in itself is not a tax measure but a transparency and corporate responsibility measure. It will have no direct effect on the tax rate imposed on reporting institutions. Any increase in effective taxation would only be an indirect result. It is very difficult to predict the likelihood of a possible increase of (effective) tax rates indirectly resulting from CBCR. This would depend on various factors such as the institution's current approach to tax matters, the response by authorities to the disclosure of the information on all the tax payments on a country-by-country basis and the public response to the published CBCR data. Even if a reporting institution would change its tax approach, it would still be difficult to determine whether this was an indirect effect of CBCR, or would rather result from other developments in this area. Such an increase could possibly also have a positive effect on competition, in the sense that it could contribute to improving the level playing field for smaller institutions which do not operate cross border. More in general, the overall economic impact of any increase of effective tax rate would be very difficult to measure and would depend on different outcomes.[13] While on the negative side a reduction in the economic activity of the reporting entity could be expected, there are likely to be counterbalancing factors such as the availability of additional receipts for government spending which could provide benefits to society and the wider economy, and an increase in public confidence.

B. Impact on investment

Stakeholders were asked about the effects of CBCR on investment in and by reporting institutions.[14]

With respect to the first question, namely the effect of CBCR on investment in reporting institutions, a majority of stakeholders expect that there will be no impact. They consider that investment decisions are based on factors other than the data to be disclosed under Article 89 and that investment decisions are driven by potential economic benefits rather than disclosure driven. It is also noted that institutions applying for funding on the capital markets have already to provide more detailed information than is required by Article 89.

There is however some concern that in individual cases an institutions' attractiveness in the capital market would be negatively affected if disclosures are misunderstood and/or perceived negatively by the public. Also, some stakeholders submit that the introduction of CBCR could create level playing field concerns and that the additional disclosure requirements could decrease the attractiveness of the EU as a location for investment (due to the associated administrative burden and cost). However, most stakeholders agree that CBCR will not affect the willingness of reporting institutions to remain in the EU.

Some stakeholders expect a positive effect on investment in reporting institutions. They argue that there is a growing global demand from investors for more transparent and more reliable (or more

[13] For more details, see the report of the external contractor pages 93-96.

[14] See the summary of the discussion at the outreach event, the responses to the public consultation, the summary of the responses to the G-SIIs consultation and the report of the external contractor, pages 140-141.

comprehensive) data on the companies they invest in. The disclosure would provide investors with a stronger basis for making sound investment decisions and would increase their ability to hold banks to account. Transparency, including CBCR, would help investors to identify risk factors and financial irregularities and would lead to better risk management by institutions. It would thus lead to increased stability in the banking sector, making it more interesting for investment. Finally, it is argued that investors are increasingly considering factors such as sustainability and transparency in investment decisions and that disclosure may attract more investment from socially responsible investors.

With respect to the second question, namely the effect of CBCR on investments made by reporting institutions, the vast majority of stakeholders consider that there would be no impact.

The results of the econometric analysis suggest that CBCR is unlikely to have a negative impact on investment. On the contrary, it is found that one additional point in the disclosure index decreases effective cost of equity capital by 0.2% points. Therefore, 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. This may translate into lower lending rates and enable firms to invest more in their business and expand.[15]

Also the literature review suggests that improvements in overall disclosure are associated with better firm outcomes in capital markets such as lower cost of equity, due to lower asymmetric information and lower agency costs. A reduction in the cost of equity has been linked with greater investment both of the financial and non-financial sector.

C. Impact on credit availability

Stakeholders were asked about the effects of CBCR on the provision of credit to reporting institutions and by reporting institutions.[16]

With respect to the first question, namely the effects of CBCR on the provision of credit to reporting institutions, a large majority of stakeholders consider that there will be no impact.

A small minority of stakeholders are concerned that there could be a negative impact. It is argued that the disclosures could be misunderstood and lead to negative sentiment. In particular with respect to the information on public subsidies, one stakeholder argues that this could lead to a perception of a bank being “propped up”, leading to increased costs of wholesale funding.

Others expect a positive impact. Very much in line with the comments on impact on investment, it is argued that increased transparency could improve confidence in reporting institutions, that it would lead to a better understanding of company risk and therefore better risk management and lower levels of risk in the longer term.

With respect to the second question, namely the effects of CBCR on the provision of credit by reporting institutions, stakeholders broadly agree that CBCR will have impact neither on the provision of credit by reporting institutions, nor on the price or quality of credit available to businesses and households.

[15] Report of the external contractor, pages 46-55 and 84-85.

[16] See the summary of the discussion at the outreach event, the responses to the public consultation, the summary of the responses to the G-SIIs consultation and the report of the external contractor, pages 142-143.

The econometric results suggest that CBCR is unlikely to have any negative impact on banks' ability to access capital markets. On the contrary, the results suggest that one additional point in the disclosure index decreases effective cost of equity capital by 0.2% points. Therefore, the improvement in disclosure quality as a result of CBCR could even have a small impact on reducing banks' cost of equity capital, and these benefits could be passed on to non-financial sector firms and households in the form of lower lending rates.[17]

The literature review suggests that lower borrowing rates for banks can also lead to increased credit availability as banks, with protection from bigger margins, are more willing to increase lending supply.

D. Impact on the stability of the financial system

Most stakeholders[18] agree that CBCR will have no impact on the stability of the financial system. They indicate that, even if there is a potential for volatility in individual businesses, this would not affect the sector as a whole. They also note that volatility is due to a number of causes and that it would not be possible to identify volatility arising solely from Article 89 disclosures. One noted that there may be some risk of the disclosures affecting the perception of the sector, but still did not expect a noticeable impact.

Only a small minority of stakeholders disagree and mention for example that interbank lending may be impacted if detailed information on a bank's tax position is made available or point to a risk of public misunderstanding of the data due to inconsistent application and varying interpretations. These stakeholders do not argue however that the negative impact would be strong.

A few stakeholders instead expect a positive impact, commenting inter alia that increased disclosure would enable investors and other stakeholders to get a better understanding of how the financial sector is operating as well as of its patterns of ownership, would lead to a better management of risks and sustainability, and would increase confidence and reduce market volatility.

The results of the econometric analysis suggest that an increase in disclosure quality could have a positive impact on accounting quality. The results suggest that an increase in disclosure score by 1 increases the accuracy of analyst forecasts' by 0.49 % points[19] and decreases the probability of managing earnings by 3.5%[20]. 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.

Also, the literature review suggests that bank disclosures can have a positive impact on financial stability as they can alleviate problems of asymmetric information, facilitate the monitoring of the institutions and improve governance.

[17] Report of the external contractor, pages 46-55 and 84-85.

[18] See the summary of the discussion at the outreach event, the responses to the public consultation, the summary of the responses to the G-SIIs consultation and the report of the external contractor, page 144.

[19] Report of the external contractor, pages 64-72 and 84-85.

[20] Report of the external contractor, pages 73-83 and 84-85.

E. Assessment

Since the CBCR provisions have not yet fully entered into force, this assessment is essentially a forward looking exercise focussed – as required by Article 89 of Directive 2013/36/EU – on determining whether CBCR is expected to have significant negative economic effects.

CBCR is expected by stakeholders to have some positive impact on transparency and accountability of, and on the public confidence in the European financial sector. Nevertheless, it is suggested that transparency would benefit from additional guidance on the exact contents of the items to be reported and from a consistent implementation in the Member States.

The balance of opinions among stakeholders is that CBCR will have no significant impact on competitiveness, investment, credit availability or the stability of the financial system. Opponents mostly refer to a risk of public misunderstanding of the data and to an increased administrative burden. Supporters of CBCR point to a number of positive effects: investors will be able to make more informed investment decisions and be more able to hold banks to account. CBCR will lead to better risk management by reporting institutions, thus reducing the risk of scandals and increasing stability in the financial sector. CBCR will attract investors and customers that value the increased transparency and in general lead to increased trust in the European financial sector.

The results of the econometric analysis suggest that improved disclosure quality – which is a key objective of CBCR – would lead to a number of positive outcomes. Greater disclosure quality can lead to a reduction of the cost of equity capital which may be passed on to businesses and households in the form of lower lending rates and thus benefit credit availability and investment. It can also lead to a reduction in the ability of reporting institutions to mask their true performance (earnings management) and an increased accounting quality which could result in greater competitiveness and increased financial stability.

It is the assessment of the Commission, notably based on the results of the study and the views expressed by the stakeholders, that, at this stage, the public country-by-country reporting of information under Article 89 of Directive 2013/36/EU is not expected to have significant negative economic impact, in particular on competitiveness, investment, credit availability or the stability of the financial system.

On the contrary, it seems that there could be some limited positive impact. The feedback from stakeholders and analysis of the first set of confidential disclosures suggest that the beneficial effects of Article 89 could be increased by addressing some elements related to the implementation of that provision.

IV. Conclusion

At this stage, the public country-by-country reporting of information under Article 89 of Directive 2013/36/EU is not expected to have significant negative economic impact, in particular on competitiveness, investment, credit availability or the stability of the financial system. On the contrary, it seems that there could be some limited positive impact; however the beneficial effects of Article 89 could be increased by addressing some elements related to the implementation of that provision.

The Commission considers that, as no significant negative effects have been identified in relation to the public country-by-country reporting of information, the obligations under Article 89 of Directive 2013/36/EU should not be deferred and should apply, as foreseen, in full from 1 January 2015 onwards.