

<IR> Banking Network

**Applying the Integrated Reporting
concept of 'capitals' in the banking
industry**

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Introduction

Traditionally, reporting in the banking industry has focused on financial capital and, to some extent, human capital. With the emergence of a digitized world and the notion of the banks themselves under threat of disintermediation, careful consideration of the use of, and effects on, other capitals is increasingly important.

Reporting on the role of the resources and relationships used and affected by an organization, referred to collectively as “the capitals”, and their role in value creation over time is a fundamental concept in the International Integrated Reporting Council’s (IIRC’s) International Integrated Reporting (<IR>) Framework (“the Framework”).¹ Although this concept appears logical and straight forward, some industries - including the banking industry - struggle to meaningfully incorporate the capitals into their integrated reports, as a recent study by Coulson, Adams and Nugent (2015)² suggests. These issues are discussed in the context of the banking industry herein.

This paper provides insights into current practice for banks’ reporting on the capitals, outlines leading reporting practice and articulates the value proposition for banks to report on the capitals. It is meant as a brief practical guide rather than an academic analysis. As such, the paper aims not to revisit the theoretical underpinning for the reporting of the capitals, but instead contextualizes some of the practical challenges that banks face in implementation.

¹ <http://www.theiirc.org/international-ir-framework/>

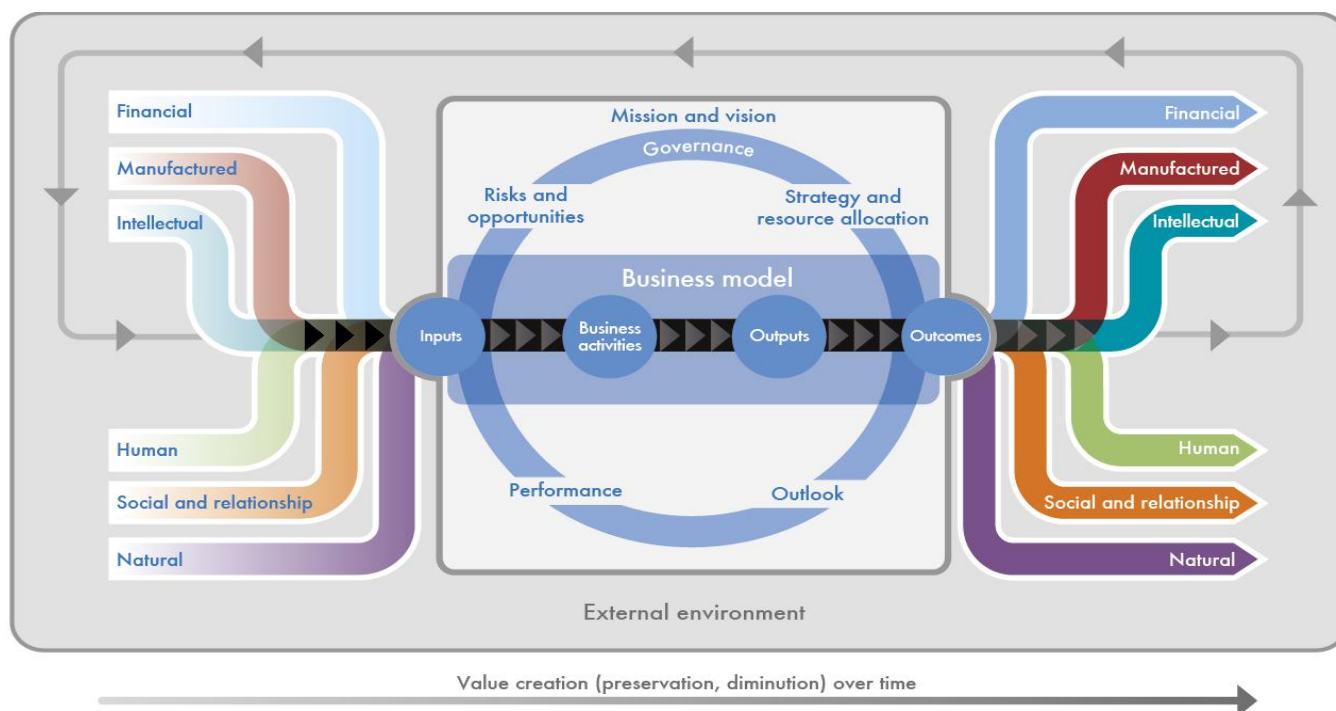
² Coulson, Adams and Nugent “Exploring metaphors of capitals and the framing of multiple capitals: challenges and opportunities” (2015) - <http://bit.ly/1fkg5MI>

Defining the capitals

The Framework defines the capitals as follows:

Stocks of value on which all organizations depend for their success as inputs to their business model, and which are increased, decreased or transformed through the organization's business activities and outputs. The capitals are categorized in this Framework as financial, manufactured, intellectual, human, social and relationship, and natural.

Banks, like other organizations, may need to be strategic in their deployment and depletion of some capitals to enhance or expand others. This is a constant balancing act to optimize the organization's ability to create value over time. Longer term business model adjustments may also be necessary to reflect expectations about the future quality and availability of key capitals. These relationships are captured in the Framework's value creation process as follows:



The causal relationships between the different capitals can be multi-fold and complex. The challenge is for banks to succinctly articulate these relationships and potential trade-offs in terms of the “net contribution” to each capital. Common examples in the banking industry may include:

- Depletion of financial capital (cost) to increase the value of human capital (e.g., via training)
- Depletion of financial capital (cost) through R&D to strengthen intellectual capital (e.g., in the age of “Digital Banking”, banks have increased spending on R&D).

These examples show a relatively linear causal effect and are to some extent measurable. Naturally, there are caveats; for example, work force capabilities are unlikely to benefit from funds invested in ineffective training.

More complex, indirect and non-linear relationships might include the following examples:

- Through its lending decisions, a bank can impact indirectly its surrounding environment. If a borrower uses its borrowed funds to negatively impact the environment, the bank may have increased its short term financial capital at the long term expense of its social capital and possibly eventually its financial capital if it leads to a negative reaction with existing or prospective customers. This is a typical example of what is considered “sustainable lending practices.”
- Banks incur cost and time (human and financial capital) in interactions with regulators. This helps to build social and relationship capital.
- Bank employees engage in corporate social responsibility (“CSR”) activities and in doing so increase the social and relationship capital (e.g. brand) at the expense of financial and human capital (cost of time spent).

The purpose of reporting on the capitals

Reporting on capitals is not an objective in its own right. Rather it serves as a means of focusing the integrated report on the factors that are most important to the underlying sustainability of the organization.

Stored value or impact on society

It is relevant to ask if the purpose of an integrated report is to show:

- A. an organization’s ‘stored value’ - i.e. value generated through actions that have yet to be reflected in an increase in financial capital via the income statement and balance sheet. For example, the growth of brand value or employee satisfaction can have lasting long term value, yet may actually deplete earnings and equity in the short term; or
- B. the impact an organization has on its surrounding society and environment.

Paragraph 2.4 of the Framework suggests both:

Value created by an organization over time manifests itself in increases, decreases or transformations of the capitals caused by the organization’s business activities and outputs. That value has two interrelated aspects - value created for:

- ***The organization itself, which enables financial returns to the providers of financial capitals;***
- ***Others (i.e., stakeholders and society at large).***

The Background Paper, “Capitals – Background Paper for <IR>”³ focuses on the concept of “stored value”.

The term “capitals” as used in this Background Paper for <IR> refers broadly to any store of value that an organization can use in the production of goods or services (paragraph 2.8).

Capitals as a store of value is particularly important for banks because investment in some of the most critical capitals for long term viability, such as employees, brands, processes and know-how can take an extended period before resulting in an increase in financial profits. This is discussed further below.

Trade-offs between capitals and incentives

In the preceding section we outlined specific examples for the banking industry where one capital may be depleted to increase or enhance another.

Banks, similar to most other organizations, are resource constrained and thus will have to make trade-offs between the stocks of their respective capitals. This is at the core of strategic planning and tactical execution and is what ultimately creates the competitive advantage for banks. Does a bank:

- Settle a spurious lawsuit to improve its brand?
- Decline client engagements where the profile does not meet the risk or ESG profile (e.g. “sustainable lending practices”)?
- Offer banking services even where not financially profitable?
- Pay bonuses to employees and/or senior management or pay out dividends?
- Pay more tax in a country than required by law to improve standing with regulators and the public?

What investors and other stakeholders want to know is how banks make these difficult decisions and how management is incentivized in this respect. The Framework makes the following observation in this respect:

Because value is created over different time horizons and for different stakeholders through different capitals, it is unlikely to be created through the maximization of one capital while disregarding the others. For example, the maximization of financial capital (e.g., profit) at the expense of human capital (e.g., through inappropriate human resource policies and practices) is unlikely to maximize value for the organization in the longer term (paragraph 2.9).

³ <http://integratedreporting.org/wp-content/uploads/2013/03/IR-Background-Paper-Capitals.pdf>.

Value proposition to banks

The Price/Book (“P/B”) value for banks has generally been below that of many other industries in the wake of the financial crisis⁴ with P/B often close to one. But this was not always the case. The sharp decrease in P/B for some banks has often been expressed by market commentators as a loss of confidence in banks. There are now increasingly focused efforts by banks to revamp their business models and work through any legal backlogs.

Banks rely predominantly on intellectual, human, and social and relationship capitals to create competitive advantage and their relevant values are generated through deliberate, targeted and sustained efforts, often by conscious financial capital depletion in the short term. The Return on Equity (RoE) on a campaign to create a “Digital Bank” would arguably be a multi-year effort. The same can be said for the sustained efforts banks have taken to revamp their business practices in line with public expectation in the wake of the financial crisis in the 1990s.

Herein lies the compelling value proposition for banks to articulate – and ideally quantify – in the best possible way. What is the store of value that they intend to create and, where possible, what is the timeframe over which intended financial outcomes are anticipated? The expectation is not that all value can, or even should, be quantified in dollars and timeframes; however, meaningful performance indicators should be used and reported consistently. This is discussed further in the next section.

It is worth highlighting recent and significant increases in the quantity and quality of disclosures around financial risk emanating from banks’ activities. This would seem in line with the International <IR> Framework. A challenge remains for the banking and other industries to effectively link disclosures around strategy, risk and financial results.

Choosing the capitals in the banking industry

Arguably, a bank should manage its capitals in a manner congruent with how they are reported externally. Ideally, the former precedes the latter.

Banks should look internally to determine if and how they measure their “stores of value” (capitals). For example:

- Some banks emphasize “brand recognition” as an important key performance indicator (KPI) whilst others see this as outside the banks’ control and hence not part of the management KPIs.
- Some banks aim to measure their “social impact” from lending, whilst others focus only on the direct outputs (loans).
- Some banks focus on diversity as a measure of human capital, whilst others hold a philosophy of “best person for the job”.

All of these are strategic choices driving the KPIs. The subsequent section indicates the common capitals that banks today report on.

⁴ http://csimarket.com/Industry/Industry_Data.php.

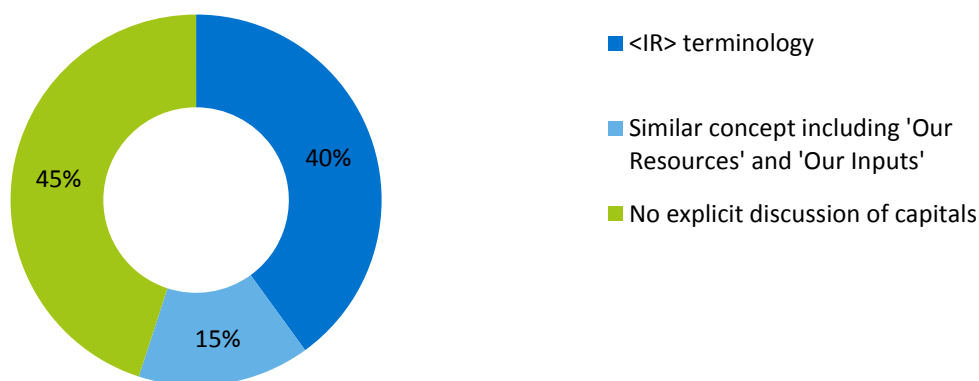
Reporting of capitals in practice

We surveyed a sample of 20 banks’ annual reports from the following population⁵:

- Members and associates of the <IR> Banking Network.
- Public banks listed on the Johannesburg Stock Exchange, which are required, on an “apply or explain basis”, to publish an integrated report.
- Banks whose capital disclosures are highlighted in the <IR> Examples Database⁶.

A listing of the banks surveyed for this paper can be found in the Appendix. The survey is not meant to represent a statistically valid sampling of all banks in the industry.

Application of 'Capitals' Concept by Banks



⁵ Where possible we reviewed the 2014 reports. We note that the International <IR> Framework was released in December 2013 and thus reports may not have had the chance to incorporate the Framework’s principles.

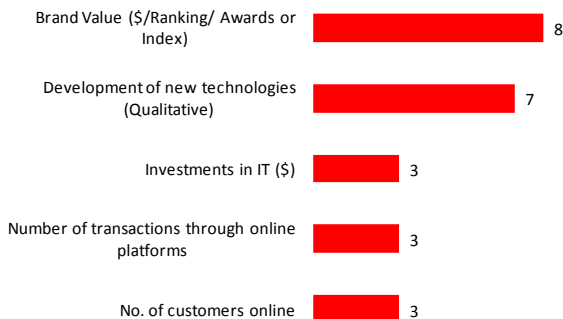
⁶ <http://examples.integratedreporting.org/home>

An overview of how banks are reporting capitals today is presented in the table below.

Categories of capital	Components of capitals	No. of banks reporting on capital	Top KPIs reported by banks applying 'Capitals' or similar concept	Other KPIs reported
Financial capital	<ul style="list-style-type: none"> Pool of funds available from diverse sources 	<p>11</p>	<ul style="list-style-type: none"> Cost-income or efficiency ratio (%) 9 Return on equity (%) 9 Total Capital (\$) 8 Capital ratio (%) 7 Loan portfolio mix (%) 6 Net profit (\$) 6 	<ul style="list-style-type: none"> Earnings per share (\$) Revenue (\$) Dividends (\$) Fee income Total assets (\$) Credit loss ratio (%) Credit ratings Customer deposits (\$) Market share (%) Operating expenses (\$)
Manufactured capital	<ul style="list-style-type: none"> Branches and network Plant and equipment Information technology 	<p>9</p>	<ul style="list-style-type: none"> No. of branches/ offices 8 No. of ATMs/ touchpoints 6 No. of active internet/ mobile banking clients 4 No. of regions in which the bank operates 4 Investments in technology (\$) 4 	<ul style="list-style-type: none"> Investments in branch transformation (\$) Number of enquiries and transactions on online platforms Rent and related expenses (\$) Processing capacity Data storage capacity Number of IT systems

Intellectual capital

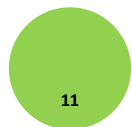
- Brand and reputation
- Processes and procedures
- Information technology
- Innovation capability



- Social networks presence
- Personnel training expenses (\$)
- Training hours per employee
- Number of training courses

Human capital

- Skills, capabilities, knowledge and experience of employees
- Management and leadership



- Number of employee training hours
- Number of employees attending leadership programs
- Occupational Health and Safety statistics
- Disciplinary and grievances statistics
- Staff cost (\$)
- Employee satisfaction (%)
- Employee tenure (Years)
- Number of merits and promotions

Social and relationship capital

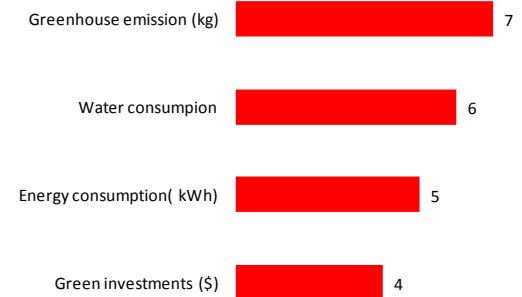
- Relationships with stakeholders and the communities
- Banking licenses



- Complaint response time (Days)
- Distribution of suppliers
- Number of SMEs supported
- Number of volunteers
- Number of employees who attended trainings on information Security, Fraud Prevention etc.
- Sustainability index ratings
- Customer growth rate
- Number of suppliers by activities
- Number of meetings and roadshows

Natural capital

- Environmental resources



- Paper consumption
- Waste volume
- Environmental safety expenses
- Application of Equator Principles (number of projects)

The following observations can be made on the basis of the survey:

1. Of the surveyed banks, eight applied the <IR> ‘capitals’ terminology as outlined in the Framework and three others applied a similar concept but used alternative terms – including “Our resources” and “Our inputs”.
2. Banks applying the Framework tend to report on all six capitals, whereas banks that apply similar concepts tend to be more selective. For example, manufactured and natural capital tended to go unaddressed by the latter group.
3. Banks provide KPIs for outputs and outcomes, but tend to overlook inputs and net contribution.
4. The greatest consistency in KPIs relates to financial capital, perhaps unsurprising given its familiarity. It is also the capital most easily quantified and considered most directly relevant to investors. Quantitative KPIs for the other capitals tend to vary. In particular, the KPIs reported under social and relationship capital vary from customer to supplier to community initiative statistics.
5. Brand is mentioned generally by banks as part of intellectual capital. The Framework considers brand to be part of social and relationship capital. Similarly, the metric “training hours” is used by some banks under the banner of human capital and by others under intellectual capital. One bank stated that intellectual capital was closely related to financial, human and manufactured capital; however, no KPIs related to intellectual capital were provided. These mixed findings suggest possible confusion or disagreement with the Framework’s definition of the various capitals.
6. For some capitals, the KPIs reported are not uniquely conclusive. For example, in the age of digitalization, is it positive to have more branches or fewer branches? And is there a “right” male/female ratio in the workforce?
7. For intellectual and human capital, some banks report a number of qualitative KPIs (not shown) indicating the difficulty of finding good quantitative measures for these capitals.
8. Some of the KPIs reported require more definition. For example, what is the definition of an “ethical investment”?
9. At least seven banks report on their use of natural capital, despite the common observation that banks are not large consumers of physical capital. Part of the explanation may be that banks are also reporting in line with an ESG or sustainability framework, such as that developed by the Global Reporting Initiative.⁷

⁷ Global Reporting Initiative – www.globalreporting.org

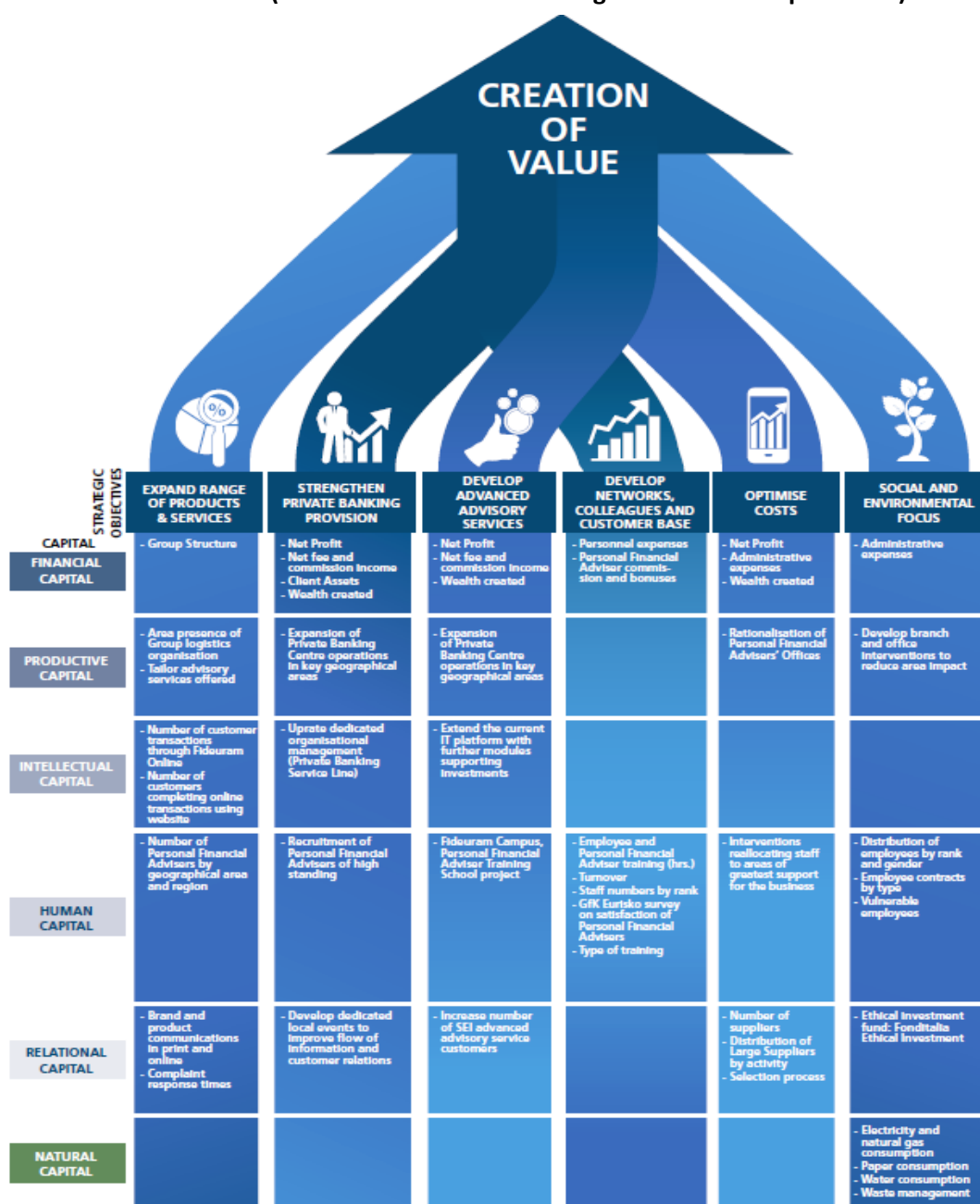
Towards the next level of reporting

Examples in the financial industry

The <IR> landscape is still evolving. Whilst the six categories of capitals in the Framework provide a helpful tool for banks to systematically identify their stocks of capital, it should be recognized that not all capitals are equally relevant or applicable to banks. For example, whilst banks may interact with natural capital to some extent, in most cases it may not be sufficiently material to be included in the integrated report.

Below are some examples of how banks are reporting on the capitals today. These examples that may provide inspiration on how the capitals can be integrated into a bank's external reporting.

Banca Fideuram links each category of capital to its six strategic objectives and KPIs that measure the value created. (Source Banca Fideuram Integrated Annual Report 2013)



Barclays Africa Group links each category of capital to its balanced scorecard component, which in turn links to how performance is measured. (Source: Barclays Africa Group Limited Integrated Report 2014)

Capitals	Financial	Human	Intellectual	Manufactured	Natural	Social and relationship
Balanced Scorecard component	<ul style="list-style-type: none"> Capital and liquidity management capabilities Credit rating strength Access to financial services for underbanked and small and medium enterprises Access to capital markets Creating shareholder value Contributing to taxes 	<ul style="list-style-type: none"> Our employees, their competencies and skills Effective leadership Company culture to help people achieve their ambitions in the right way Investment in learning and development 	<ul style="list-style-type: none"> Application of current technologies Development of new technologies Specialised financial skills and expertise Brand reputation 	<ul style="list-style-type: none"> Our branches and call centres for customer service Data centres and support function premises Equipment and technology resources that enable service delivery 	<ul style="list-style-type: none"> Energy needs (including electricity, renewable energy, gas and diesel) and paper consumption are the most significant Water consumption Our environment and social lending practices 	<ul style="list-style-type: none"> Dialogue and interaction with stakeholders Management of socio-environmental risk and opportunities through our lending, investing and procurement practices Social responsibility including community investments, access to financial services and financial education
Customer & Client						
Colleague						
Citizenship						
Conduct						
Company						

Our performance is measured through the Balanced Scorecard



Notes

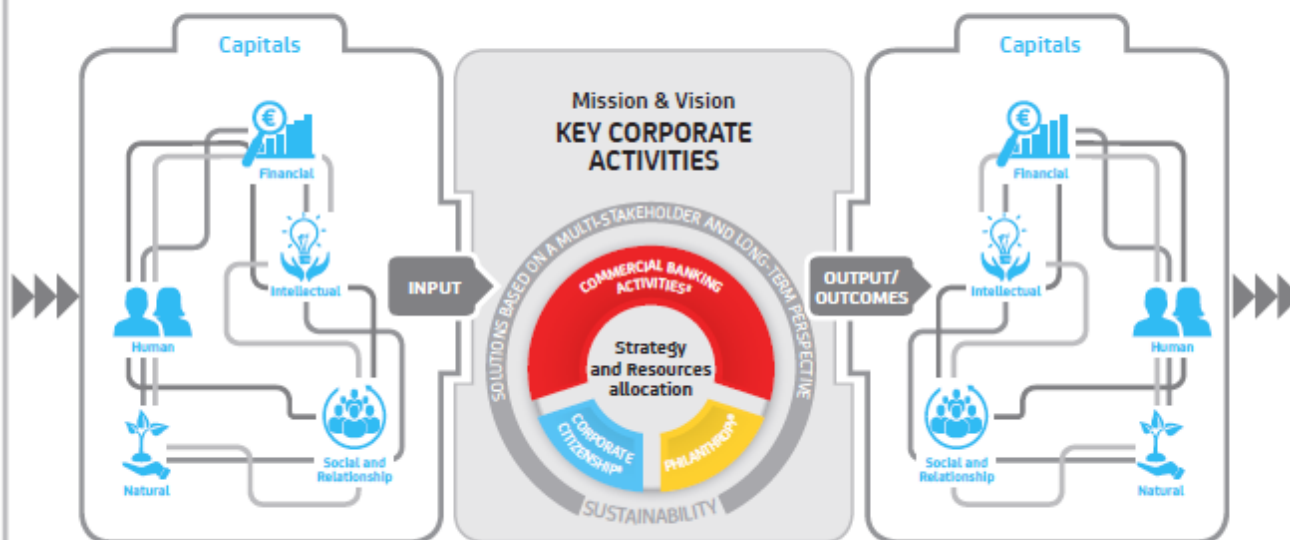
¹ Bi-annual metric
² 2013/2014 growth rate
³ Employee opinion survey

⁴ South Africa
⁵ Botswana, Ghana, Kenya, South Africa and Zambia

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^{LA} – Limited assurance

UniCredit discusses its capitals in a broader social and economic context and links its stocks of capitals to initiatives undertaken for each category, outputs/outcome and priorities for the coming year. (Source: UniCredit 2014 Integrated Report)

UniCredit's value creation process^A in a broader social and economic context



A. Source: adapted from the IIRC framework.
B. Refer to 2013 Sustainability Report for definitions.

UniCredit holds significant responsibilities within a complex value chain and we use different types of capitals - financial, human, social and relationship, intellectual and natural - as inputs to contribute to our economy and society at large. These inputs are essential to our Business Model and the use we make influence the quality of the products and services that we provide, i.e. our outputs.

We have also studied our impacts extensively, and we have become ever more aware of the vital role we play in the real economies of the countries where we operate (outcomes). A responsible approach guides everything we do, from our core banking activities to our corporate citizenship initiatives. These initiatives emphasize financial inclusion and education, complementing our philanthropy in the field of social inclusion. We strongly believe that communities that provide a genuine diversity of opportunities nurture the innovative environment that enables both people and businesses to thrive.

Our Results

10.26%
Common Equity
Tier 1 Capital Ratio

↑ 77%
engagement index

↑
Customer
satisfaction
improving

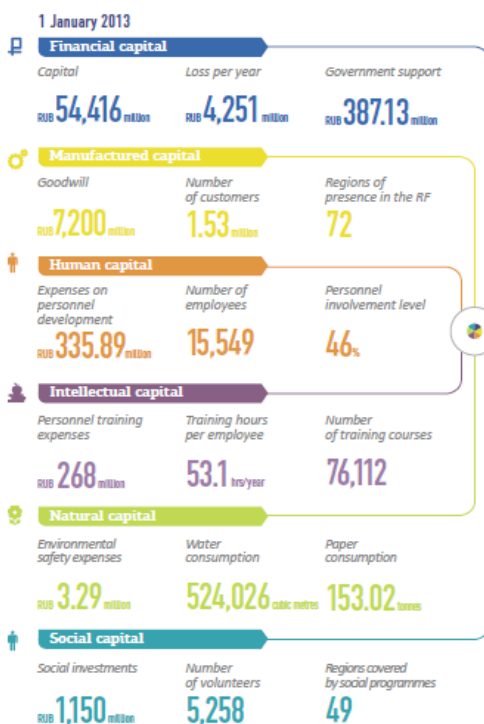
↓ -29%
GHG emissions versus
our 2008 base year

	Stocks of capitals	Initiatives	Value for UniCredit	Community impact	Priorities 2015
Financial	<ul style="list-style-type: none"> Solid equity position Balanced funding mix Long-term financial stability 	 Read more at page >> 52-53	<ul style="list-style-type: none"> Performance improvements Sustainability and competitiveness Efficiency enhancements Investment attraction 	<ul style="list-style-type: none"> Support for the economy Investor and employee remuneration Public administration contributions 	<ul style="list-style-type: none"> Revenue and net profit growth Commercial loans augmentation
Human	<ul style="list-style-type: none"> Engaged people Competent and skilled professionals Diversified workforce 	 Read more at page >> 54-57	<ul style="list-style-type: none"> Performance improvements Sustainability and competitiveness Innovation expansion Common corporate culture 	<ul style="list-style-type: none"> Empowerment and dissemination of skills Merit and transparency Equal opportunities Greater well-being 	<ul style="list-style-type: none"> Enhancement of talent development programs Enhancement of sustainability and competitiveness through investments in Strategic Workforce Planning¹
Social and Relationship	<ul style="list-style-type: none"> Long-term stakeholder relationships Socio-economic development/wellbeing 	 Read more at page >> 58-67	<ul style="list-style-type: none"> Client retention and acquisition Revenue and market share enlargement Product and process amelioration Reputation enhancement 	<ul style="list-style-type: none"> Customer satisfaction Financial inclusion Responsible financial habits Companies competitiveness Social inclusion 	<ul style="list-style-type: none"> Customer engagement activities to improve overall satisfaction Local financial education program enhancements Strong partnerships and initiatives focused on key social issues for greater community inclusiveness
Intellectual	<ul style="list-style-type: none"> Effective and safe ICT system Efficient and effective processes Innovation capability 	 Read more at page >> 68-71	<ul style="list-style-type: none"> Performance improvements Sustainability and competitiveness Client retention and acquisition 	<ul style="list-style-type: none"> Customized products and services Friendly and simple relationship Business continuity and security 	<ul style="list-style-type: none"> Transformation of the Group through the implementation of ICT and Operations Strategy Enhance process culture through the dissemination of a common processes' taxonomy Industrialization of new personalized and digital native products/services
Natural	<ul style="list-style-type: none"> Air quality conservation Soil, water, flora and fauna conservation 	 Read more at page >> 72-77	<ul style="list-style-type: none"> Environmental risk monitoring and mitigation Energy consumption reduction Green investments opportunities Reputation enhancement 	<ul style="list-style-type: none"> Renewables and energy efficiency promotion Low carbon public infrastructure financing Environmental business culture development Air quality conservation Community well-being 	<ul style="list-style-type: none"> Environmental Governance and Group environmental Strategy reinforcement Better understanding of interdependencies between natural capital and business Assessment of lending portfolio environmental impacts Promote environmentally sensitive practices in the workplace

URALSIB shows how the quantitative KPIs for each category of capitals have increased or decreased during the year. (Source: URALSIB 2013 Integrated Report)

Value Creation Chain

The Corporation's key drivers to increase investment attractiveness are effective capital utilisation, increasing operational effectiveness, developing a synergistic effect and offering complex financial services to customers across all products and services of the Company.



URALSIB | BANK

Mission
Financial services and energy of money for the benefit of a Person and the Society

- Retail bank
- Corporate bank
- Regional banking business
- Overdue debt collection

URALSIB | Private Bank

Mission
To take care of the wealth of customers and their families, offering world-class experience and expertise

- Servicing VIP customers

URALSIB | ASSET MANAGEMENT

Mission
To increase public welfare through the professional management of capital entrusted to us

- Unit investment funds
- Individual trust management
- Management of institutional assets



Mission
Value-Based Social Entrepreneurship

- Formation of a balanced investment portfolio
- Development of human capital
- Improvement of the quality of the social environment in which the Corporation and its subsidiaries operate

Target indicators by 2018



* In accordance with the development strategy of URALSIB Bank, the Group's key asset, until 2018 (approved by the Supervisory Board).



Mission
To increase the population's social benefits through professional management of capital entrusted to us

- Formation of the funded component of retirement pension
- Private pension programmes
- Corporate pension programmes



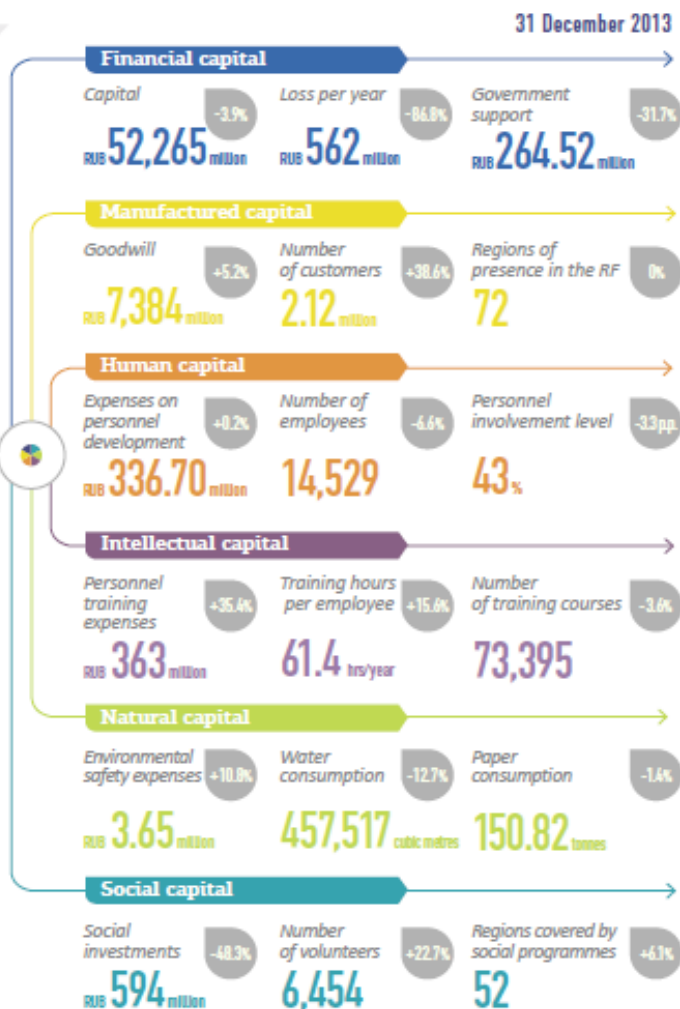
Mission
To renew and develop Russian business

- Provision of leasing services to corporate customers



Mission
To build a financial bridge between customer needs and the capital markets

- Provision of broker services to individual and corporate customers
- Corporate finances (equity capital market, debt capital market, consulting)
- Analytical research



Examples from other industries

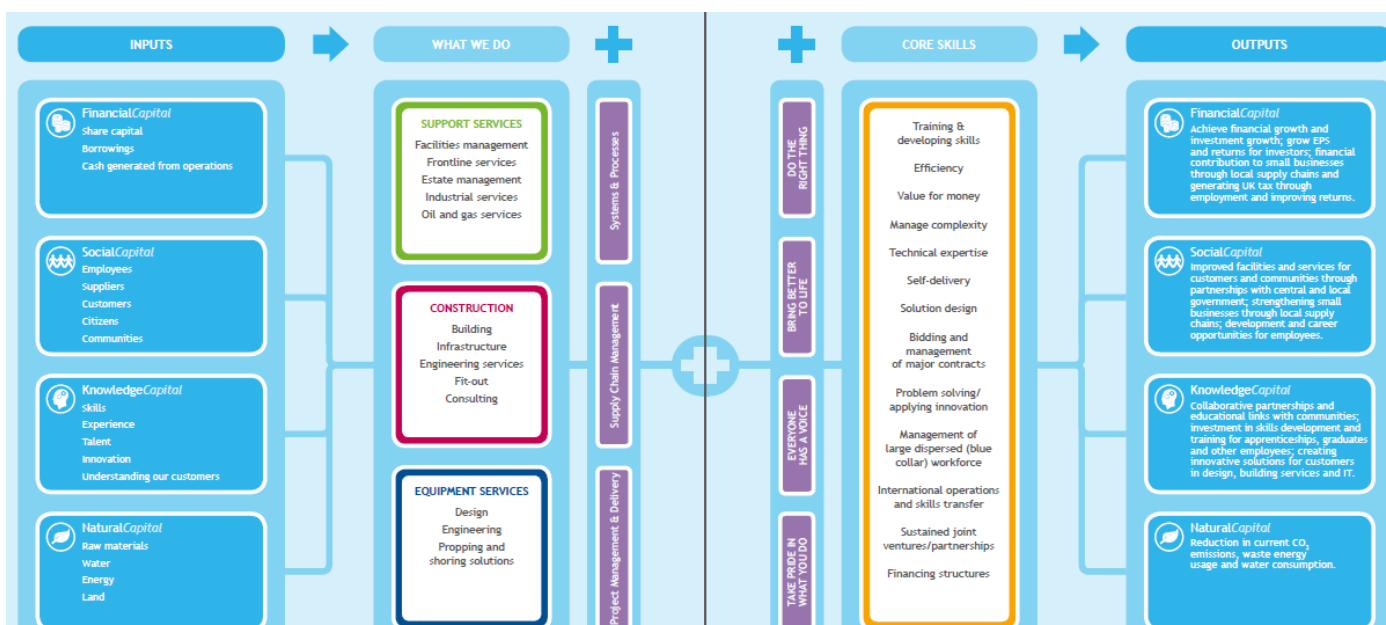
Although the banking industry is unique in its value proposition, regulatory landscape and other aspects, it shares certain common features with other industries, particularly those providing services or subject to rapid changes in technology. Inspiration for “best in class” reporting may therefore be gained from looking at how capitals are measured and reported in other industries.

Eni presents 3-year performance KPIs for each capital against each of the organization's strategic objectives (highlighted in yellow). (Source: Eni 2014 Annual Report)

Increase the value of explorative resources and growth in upstream cash generation		2012	2013	2014	
Financial capital	Capital expenditure	(€ million)	10,307	10,475	10,524
	Opex per boe	(\$/boe)	7.1	8.3	8.4
	Cash flow per boe		32.8	31.9	30.1
Productive capital	Estimated net proved reserves of hydrocarbons	(mboe)	2166	€ 130	€ 130
	Reserves life index				
Intellectual capital	Organic reserves replacement ratio				
	Existing patents [E&P]				
Human capital	First patent filing applications [E&P]				
	Employees at year end [E&P]				
Social and relationship capital	Employees outside Italy [E&P]				
	- of which locals				
Natural capital	Female employees [E&P]				
	Number of hiring [E&P]				
Financial capital	Injury frequency rate [E&P]				
	Safety expenditure and investments [E&P]				
Productive capital	Employees covered by potential assessment (young graduates and others)				
	Employees covered by performance assessment tools (senior managers, managers/supervisors and young graduates) - [E&P]				
Intellectual capital	Training expenditure [E&P]				
	Interventions on the territories from agreements, conventions and PSA (community investment)				
Human capital	Direct GHG emission [E&P]				
	- of which CO ₂ equivalent from flaring				
Social and relationship capital	CO ₂ eq emissions/100% operated hydrocarbon gross production				
	Volume of gas sent to flaring				
Natural capital	Oil spills due to operations (> 1 bbl)				
	Produced water re-injected				

Return to structural profitability in the Gas & Power business		2012	2013	2014	
Financial capital	Adjusted operating profit	(€ million)	398	(638)	310
	Operating expenses reduction	(N)	9	(10)	(15)
Productive capital	Worldwide gas sales	(bcm)	95.32	93.17	89.17
	LNG sales	(bcm)	14.60	12.40	13.30
Intellectual capital	Customers in Italy	(million)	745	8.00	793
	Electricity sold	(TWh)	42.58	35.05	33.58
Human capital	Existing patents [G&P]	(number)	46	56	43
	First patent filing applications [G&P]		3	0	0
Social and relationship capital	Employees at year end [G&P]	(number)	4,682	4,445	4,136
	Employees outside Italy [G&P]		2,626	2,336	2,191
Natural capital	Female employees [G&P]		1,442	1,397	1,312
	Number of hiring [G&P]		222	179	68
Human capital	Injury frequency rate [G&P]	(No. of accidents per million worked hours)	2.23	1.43	0.49
	Safety expenditure and investments [G&P]	(€ million)	12.3	8.9	7.1
Productive capital	Employees covered by performance assessment tools (senior managers, managers/supervisors and young graduates) - [G&P]	(N)	74	63	72
	Training hours [G&P]	(number)	167,975	147,011	92,701
Intellectual capital	Training expenditure [G&P]	(€ million)	3.0	1.9	1.2
	Customer satisfaction code (CSS)	(N)	89.70	92.90	93.4%
Natural capital	Direct GHG emissions [G&P]	(million tonnes CO ₂ eq)	12.77	11.22	10.08
	CO ₂ eq emissions/kWheq [EniPower]	(g CO ₂ eq/kWheq)	399.03	406.33	408.18
Human capital	Power generation [EniPower]	(TWh)	26.01	23.15	21.05
	NO _x emissions/kWheq [EniPower]	(g NO _x eq/kWheq)	0.16	0.16	0.15
Productive capital	SO _x emissions/kWheq [EniPower]	(g SO _x eq/kWheq)	0.027	0.017	0.001
	Water withdrawals/kWheq produced [EniPower]	(cm ³ /kWheq)	0.01	0.02	0.02

Interserve illustrates the transformation of each of their capitals from inputs to outputs through their business model qualitatively in a diagram. (Source: Interserve 2013 Annual Report)



Strate uses a simple Q&A approach to explain the resources on which they rely to ensure business success. (Source: Strate 2014 Integrated Report)

These are:

- BIS Model 1 - Gross securities and gross funds (cash);
- BIS Model 2 - Gross securities and net funds (cash); and
- BIS Model 3 - Net securities and net funds (cash).

Strate's settlement models are different for each type of security. Strate's equities settlement model is mainly designed on the BIS Model 3 (net securities and net funds), which means that trades are netted, resulting in a lower number of settlement transactions being processed. As a result, changes to Strate's revenue do not necessarily correspond with changes in trading volumes.

There are various types of transactions that Strate processes for which it has determined fixed individual fees based on the effort and associated cost. Strate's clients require it to regularly review its pricing structures, as they are sensitive to price increases.

Key resources - What do we require in our business to operate successfully?

There are several resources that are required in order for Strate to operate successfully. Strate's licence to operate, its Information Technology (IT), people and knowledge of the financial markets are imperative to successfully run the business.

First and foremost, Strate's licence to operate is vital, as without it, Strate does not have a business. Strate operates under a licence that has been awarded to it by its regulator, the Financial Services Board (FSB), which authorises Strate to be a CSD in South Africa. Performing such a function without a licence is in breach of legislation.

IT is a key enabler of Strate's services. Strate's IT infrastructure includes various systems and applications that are required for the daily processing of transactions. The infrastructure includes mainframe, open systems architecture, enterprise storage and networks (such as wide area, local area and the Society for Worldwide Interbank Financial Telecommunication (SWIFT) networks).

As a rule, Strate does not develop IT applications in-house. It partners with international experts in this area. This has improved both the quality and the time frame of delivery of the applications that are required to fulfill Strate's duties as a CSD.

People form the cornerstone of Strate's business. Specialised skills and knowledge are required throughout the organisation. Strate uses a co-sourcing model in various areas, more extensively in IT and, as a result, there are several external vendors providing additional support to Strate's business. Strate sees this model as a risk mitigating action to ensure continuity of critical functions.

Financial soundness is an imperative for a Financial Market Infrastructure (FMI). Strate, as an FMI, performs a critical role in the financial markets and sufficient reserves and funds are required to ensure the continuation of operations - even during adverse market conditions.

In order to attract and retain international investment, it is essential that Strate provides CSD services at an international level. To achieve this, it is necessary for Strate to have infrastructure that is comparable with its international counterparts. This has required a large upfront investment that needs to be maintained.

Key activities - What important things must we do to make our business a success?

Engagement with Strate's stakeholders and a thorough understanding of their needs and expectations is key to Strate's strategic direction and its sustainability. Significant effort and time is spent engaging with its stakeholders in meaningful dialogue.

Strate has obligations in terms of its CSD licence and the adherence to these are always top of mind.

Strate's licence to operate includes the responsibility for:

- The provision and maintenance of infrastructure for holding, settling and administering uncertificated securities;
- The issuing, amendment and suspension, where necessary, of Rules and Directives according to which the market must operate. Strate has a Legal and Regulatory Division that is staffed by regulatory specialists who draft Rules and Directives; and
- The supervision of compliance with the Rules and Directives by the CSD Participants. This function has the potential for conflict of interest to exist, or be perceived to exist, between the Supervisory function and other services undertaken and performed by Strate as the CSD. Appropriate 'Chinese Walls' have been established between these functions. The STRATE Supervision Division reports to the CEO

SASB KPIs for the banking industry

The Sustainability Accounting Standards Board (SASB) has produced standards and briefs⁸ for the banking industry, outlining the perceived material issues and proposed KPIs for reporting purposes. Although the SASB guidance is focused on sustainability reporting, many of the issues and KPIs can provide inspiration when developing an integrated report. Selected examples include:

Capital*	Issue	KPI	Example
Human	Talent Development	Training hours per employee	Internal data
	Customer Privacy	Number of cybercrime incidents	Internal data
Social / Relationship	Social inclusion	Amount / % lent to customers deemed “low income / unbanked”	Use national definition of “poverty level”
	Regulatory Compliance	Amount for provision and settlement of regulatory and tax issues.	Internal data
	Cyber Security	Number of security breaches	Internal data
Natural	Sustainable Lending Practices	Amount / % lent to companies deemed “high climate risk exposure”	Use definition from IPCC (www.ipcc.ch) or Norske BankFund (http://www.nbim.no/en/responsibility)

*SASB uses a different naming convention for the capitals

⁸ <http://www.sasb.org/sectors/financials/>

Beyond capital - illustrating the value creation process

The Framework envisions that organizations illustrate, in a succinct fashion, how they increase, decrease or transform the capitals through their business activities and outputs. The net impact on each capital can conceptually be seen as the “Net Contribution” over a period. Reflecting the net contribution is thus a way of stating the strategic and tactical trade-offs an organization has made during a period (ex-post) in terms of depleting some capitals to grow or improve others. An organization may extend this by also stating how it intends to make trade-offs between capitals generally and/or in a future reporting period.

The interactions between capitals are multiple and complex. A question then arises as to whether a bank aims to exhaustively report on the material interactions and correlations or instead aims to prepare a succinct representation. The risk of the latter approach is that it may amount to only an illustrative pictogram with insufficient detail for investor decision making.

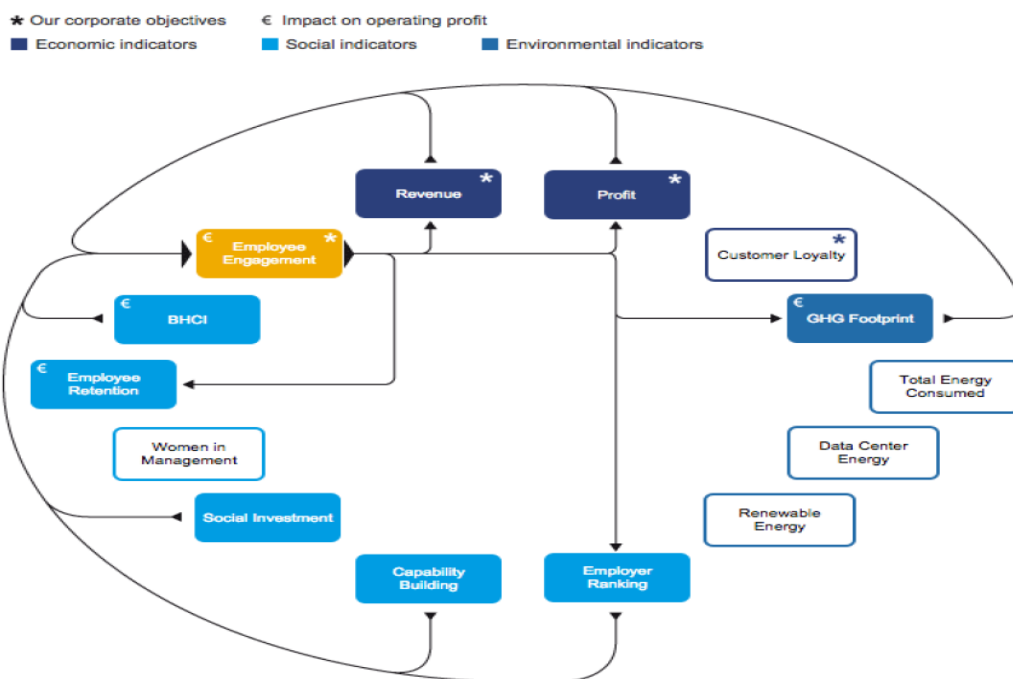
Another issue that arises from different approaches to reporting is whether an organization aims to quantify the capitals used, created or transformed and, if so, if it aims to “monetize” the capitals (i.e., report monetary KPIs for its inputs, outputs and outcomes). This complex topic is beyond this paper. Two examples of how organizations are trying to approach the issue are highlighted below.

SAP

In its 2014 Integrated Report, SAP has made significant efforts to qualitatively explain the links they believe exist between inputs and outputs. The Integrated Report stops short of quantifying the net contribution over a period. SAP states:

Over the past several years, we have sought to create a framework to establish concrete links between nonfinancial and financial performance. This year, we took our efforts one step further, determining how four social and environmental indicators - our Business Health Culture Index (BHCI), employee engagement, retention and emissions - impact SAP’s operating profit.

The organization then proceeds to explain each of the major relationships between capitals and even goes as far as estimating the impact of those relationships. For employee engagement, SAP reports the following:



Employee engagement is the level of employee commitment, pride, and loyalty, as well as the feeling of employees of being advocates for their company.

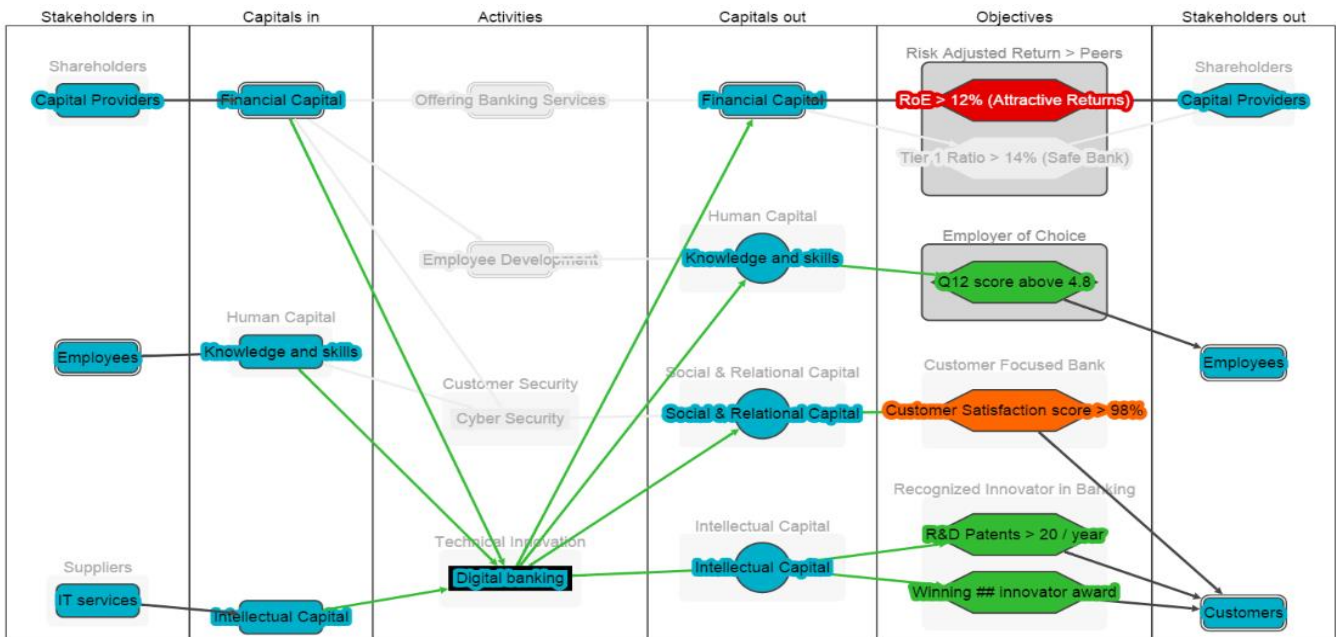
Employee Engagement: A change by one percentage point of Employee Engagement would have an impact of 35-45 million € for SAP's operating profit.

Value creation flowchart

Considering the complicated interactions amongst the capitals, banks may choose to develop internal flow charts to systematically consider the material causal relationships between capitals. Such tools are being explored and becoming available as evidenced in the example below.

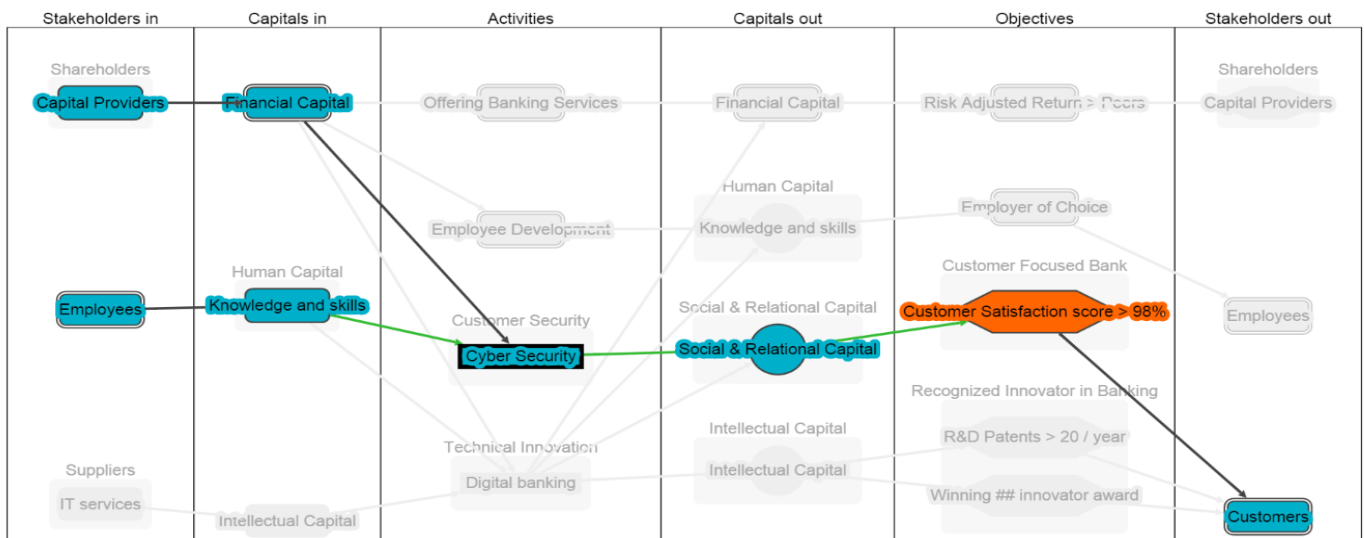
The tools can be used both as an internal management tool as well as a succinct communication in the external integrated report. Two examples of relationships specific to banks can be used to illustrate how the model works.

Example 1 – digital banking. This example focuses on an R&D process with the inputs being financial, human and (3rd party) intellectual capital. The first two are depleted via cost and hours spent. The short term output is customer satisfaction; it increases human capital (knowledge) and thus employee engagement and it could lead to recognition as an innovator. Longer term objective is RoE.



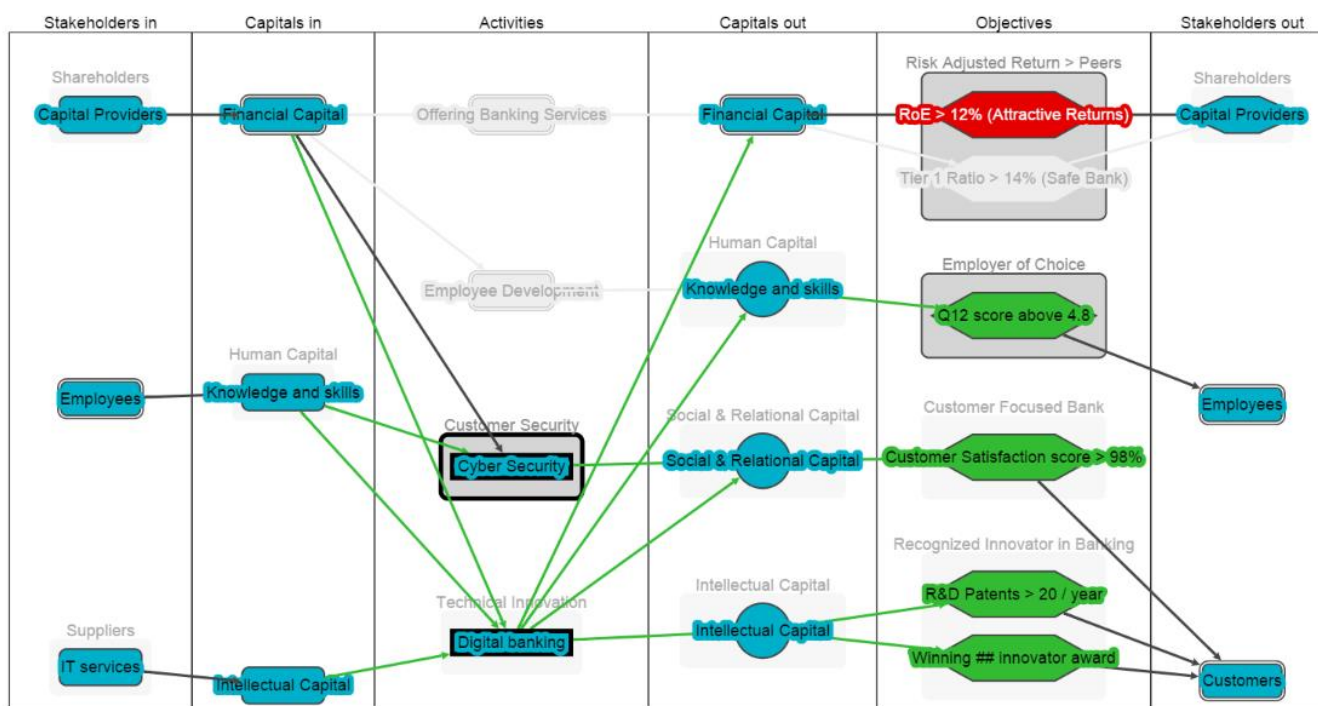
Source: S4SB Value Creation Framework

Example 2 – cyber security. This example focuses on ensuring/enhancing Customer Security. The inputs are financial and human capital. No short term increase in profit is expected as customers expect this as basic reporting requirement. What it does is MAINTAIN customer relationships and social capital (more specifically it forms the license to operate in markets).



Source: S4SB Value Creation Framework

The idea then is to aggregate similar activities “bottom up” to arrive at continuously more aggregated views of the relationships. For example, the combined effect of the two activities in the examples (call it Secure - Digital Banking) helps to achieve the Customer Satisfaction Objective (green):



Source: S4SB Value Creation Framework

The challenge will be for organizations to find a meaningful level of aggregation to report in the external integrated report.

Concluding remarks

In this paper, we aimed to illustrate how the fundamental concept of the capitals can be applied in the banking industry. Our study suggests that while only the minority of banks included in our survey apply the Framework’s definitions or categories of capital strictly, the majority have some notion of how they use or transform resources. This indicates an acceptance of the importance of managing and reporting more holistically on the capitals.

In practice, the quantification of capitals-related performance seems to have focused on “outputs” rather than “inputs” or net contributions. There is also a fair amount of overlap between the KPIs reported. Our industry can learn from “best in class” disclosures in other industries with similar dependences or impacts.

Reporting on the “stored value” that banks have created and which is embedded in the capitals provides strong incentive to include clear descriptions in the integrated report. This should help investors better understand the value that banks build as they respond to the industry’s recent “banking crisis” and “digitalization banking and disintermediation” challenges.

On behalf of the <IR> Banking Network – August 2015⁹

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⁹ See <http://integratedreporting.org/ir-networks/> for the network’s depiction as “<IR> Banking Network”.

Appendix: List of banks surveyed in ‘Reporting of Capitals in Practice’

1. Banca Fideuram*
2. Barclays Africa Group Limited*
3. BBVA
4. BNDES
5. BNP Paribas
6. Capitec Bank Holdings Limited*
7. DBS Group Holdings Ltd[#]
8. Deutsche Bank
9. FMO[#]
10. Garanti
11. HSBC
12. Itaú Unibanco*
13. National Australia Bank
14. Nedbank Group*
15. Sasfin Holdings Limited[#]
16. Standard Chartered
17. Standard Bank*
18. UniCredit*
19. URALSIB*
20. Vancity

* Banks that have applied <IR> capitals terminology

[#] Banks that have applied a similar concept but used alternative terms – including “Our resources” and “Our inputs”

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