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Pillar 3, creation of the Standards Implementation Group (SIG)

IBFed/IIF Pillar 3 Briefing for Analysts

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Good morning,

It’s a pleasure to be here this morning to share some thoughts with you about Pillar 3 of the Basel II Framework. I want to start by thanking the organizers -the IBFed and IIF- for putting together the program and for all of you for attending.

Business has been anything but usual over the past 18 months, and it is tempting to “cut-back” on important events like this. To do so, I think, would be a mistake. We can’t, as supervisors, bankers and market participants, sit back and wait for the crisis to be over. We need to push ahead with our “normal” work programs, even though these are very busy times and it’s tempting to be in crisis management mode and put the rest of the things on hold.

In my talk today I will cover five areas. Firstly, I want to very briefly discuss the role of market disciple, the potential benefits of market discipline and preconditions for market discipline to be effective. Secondly, I will talk about the role of Pillar 3 in the Basel II Framework. Pillar 3 is of course about promoting market discipline. I will then discuss Pillar 3 disclosures at a very high level, I won´t go into a technical discussion of the tables. Fourthly, I think it is important to be clear about what Pillar 3 will, and will not, provide. Finally, I will discuss the role of supervisors, banks and market analysts in implementing Pillar 3. For implementation of Pillar 3 to be effective, everybody needs to play their part.

Let me start by defining market discipline as “The ability of third-party claimants (e.g. debt and equity holders) to identify risk in financial institutions and to act in a way that signals those risks (to other market participants), or changes the behaviour of a financial institution“. It is important to note that third parties do not include small deposit holders.

The financial crisis has demonstrated weaknesses in bank and supervisory practices, and it fair to say also weaknesses in market discipline. Pillar 3 will promote deeper analysis of the risk profile of banks by market participants.

The financial literature categorises market disciple into two components: (i) Market monitoring: risks are promptly impounded into a firm’s security prices (creating information that other market participants can use); (ii) Market influence: the ability of market participants to change a firm’s financial decisions. For example, funds are withdrawn from a bank which affects the funding strategy of the bank, or forces it to reduce its size or risk.

In other words third parties can affect a bank's behaviour either indirectly (via the effect of their actions on a banks publicly traded securities (particularly credit default swaps and subordinated debt) or directly (e.g. by withdrawing bank funding)1.

It is clear that market participants have incentives to monitor and discipline banks. It is also clear that participants need to be independent and have to be able to benefit from their disciplinary efforts (i.e. earn a return for their efforts), so they should be sophisticated enough to understand often complex disclosures.

We should not forget that market discipline can respond more quickly than regulation to changes in banks' risk taking. Individual actions by supervisors can be implemented quickly and effectively, however across the board changes in regulatory policies generally take much longer to implement.

I want to emphasise that Pillar 3 is "another additional lever" to strengthen the safety and soundness of the banking system, e.g. we are not saying that we want to rely exclusively on market discipline or claiming that it is perfect.

Reliable and timely information allows market participants—including investors, large depositors, and counterparties—to assess key information about a bank's risk profile, capital structure, and level of capital, and, in addition, Market discipline is an ally of supervisors. Many supervisory authorities (whether or not they have implement Basel II) face resource constraints. Given the complexity of financial institutions and financial products, it is to the benefit of supervisors to promote disclosures and market discipline, as it reduces the burden on supervisors to detect and remedy unsound banking practices.

Pillar 3 is a totally new part of the accord. Pillar 1 of Basel II - which sets the regulatory minimum capital ratio that will be disclosed by banks – existed in Basel I though in a much cruder non risk-sensitive form. Pillar 2 which is about the bank determining its own internal capital needs to cover all risks and supervisory review of that process has always existed, but has now been formalised in Basel II (thereby promoting international consistency).

I would now like to quickly cover some of the more general Pillar 3 disclosure requirements in the Basel II framework.

The Pillar 3 disclosure requirements consist of qualitative and quantitative information in the following broad areas: Corporate structure; Capital structure and adequacy; Risk measurement and management (eg credit, market, interest rate risk in the banking book and operational risk, as well as credit risk mitigation).

[1] (Source Bliss and Flannery (2001))

In general, a bank's Pillar 3 disclosures should be completed for the top consolidated level of the banking group and, in order to meet the "use test", should also be consistent with the information used by senior management and the board of directors to assess and manage the institution. Bank management has the discretion to determine the appropriate medium and location of the disclosures (eg annual reports, websites, regulatory reports).

The Pillar 3 disclosures may be fulfilled by meeting accounting requirements (such as IFRS 7). There is no need to duplicate existing disclosures. A bank should determine which disclosures are appropriate based on their materiality or importance. Financial information would be considered material if a user's assessment of a bank could change if the information were omitted.

In general, the Pillar III disclosures should be made at least semi-annually. Qualitative disclosures providing a general summary of a bank's risk management objectives and policies, reporting system and definitions may be published on an annual basis. The tier 1 and total capital ratios, and their components, along with exposures or other items prone to rapid change should be disclosed quarterly.

There is no need for banks to disclose proprietary or confidential information which is of a nature that may seriously prejudice its position. Proprietary or confidential information if shared would render a bank's investment less valuable, and hence would undermine its competitive position. However, banks must then disclose rather general information about the subject matter of the requirement, describing the fact that, and the reason why, the information has not been disclosed.

I would now like to discuss what Pillar 3 will (and will not) provide.

Pillar 1 of Basel II is much more risk-sensitive than Basel I. The chart in the presentation illustrates this risk sensitivity for corporate exposures using the advanced IRB approach. On the vertical axis is the minimum capital requirement – on the other two axes are PD and LGD. Each combination of PD and LDG results in a different minimum capital requirement. This compares with Basel I, where the capital requirement is fixed at 8 per cent, irrespective of the risk of the corporate borrower, or the seniority of the bank's claim on the borrower.

The publication of parameters such as PD, LGD, EAD will provide the market with significantly new RISK information. Note that Pillar 3 information is about conveying information to the market about the banks inherent risk and risk mitigating measures. This information is distinct from financial information that is required by accounting standard-setters.

It should be highlighted that, since the creation of the first Accord, an objective of the Basel Committee has always been to promote international consistency and comparability. Basel II (including its Pillar 3) seeks to promote international consistency of supervisory requirements. But it would be naïve to expect that banks' disclosures will be perfectly consistent and comparable. We are all aware that Banks are complex organisations – no single metric is capable of conveying all the information that is needed to make a judgement about the risk-return characteristics of a bank. Pillar 3 promotes comparability and consistency, but a deeper understanding of a bank requires further analytical work

There will be variation in the quality and "informativeness" of bank disclosures. Banks do have considerable discretion in the level of detail that they choose to disclose. For example, does a bank with a relatively high reported PD for a certain portfolio indicate that the bank's portfolio is risky relative to its peers, or that the bank is being relatively conservative in its approach? Is the higher PD offset by a lower LGD or other bank practices?

It will take effort and also time for analysts to reach conclusions to these and other questions. It will also take time for the whole process to bed down. There are also variations in supervisory practices across jurisdictions, these may be driven by legal differences, historical approaches to supervision, and national discretions built into the accord. We should remember that steps in Europe are underway to reduce these national discretions. Based on work done in the AIG, I can also say that in many cases supervisors have taken similar decisions with regard to discretions.

With respect to accounting, you should not expect the Pillar 3 risk numbers to reconcile with the accounting numbers. The concept of Exposure at Default is very different to actual exposure in an accounting sense. Note again the different aim of accounting disclosures (which is to provide financial information) to Pillar 3 which provides risk information.

Across banks there is likely to be diversity in qualitative (related to risk management practices) and quantitative disclosures (eg number of PD bands, granularity of industry and geographical distribution of exposures). However, the mix of qualitative and quantitative disclosure requirements in Pillar 3 seeks to strike a balance between the need for comparable information and institution-specific information that reflects the idiosyncratic risk of the bank.

The qualitative disclosure requirements provide banks with the flexibility to explain key aspects of their risk management systems and practices that influence their risk and returns. Quantitative disclosures on the other hand provide more comparable information, when understood within the context of relevant qualitative disclosures.

A simple comparison of the headline risk-based capital ratio is I think likely to be more meaningful than other simple ratios (such as the Basel I risk based ratio), however understanding the risk of an institution and making meaningful comparisons across banks requires more than just a simple comparison of the headline risk-based ratio (or any other ratio for that matter).

The Basel II risk based measure needs to be understood within the context of the:

(i) banks' own choices (eg Basel II offers a range of options for determining capital for a given risk; bank rating systems (TTC versus PIT), risk tolerance of the bank, the quality of management, capital planning, the robustness of stress testing etc);
(ii) supervisory discretions and other national rules (e.g. dynamic provisioning in Spain; in Australia for example IRRBB is in Pillar 1; and some supervisors may have set floors on PD or LGD for given portfolios);
(iii) even if regulatory rules were perfectly aligned, national environmental factors still differ across countries (eg accounting differences between GAAP and IFRS; depositor protection regimes; bankruptcy laws etc can all have an impact on risk measurement and capital).

While I caution against blind rote benchmarking without understanding institution specifics, risk profile and business mix, I also expect Pillar 3 will provide a clear improvement in bank disclosures, and that further improvements will occur in the future.

The effective implementation of Pillar 3 requires supervisors, banks and analysts to each play an important part.

Supervisors are promoting market discipline through the mandatory risk disclosures under Pillar 3. From time to time, supervisors will modify Pillar 3 when the need arises. I believe that later in the afternoon we will have the opportunity to discuss some of the changes to Pillar 3 that the Basel Committee is considering in order to reflect some of the lessons from the financial crisis.

Supervisors also have a role to play in educating and promoting Basel II and Pillar 3. This event is part of that process, and is similar to events conducted by supervisors in their own jurisdictions. Supervisors also have a responsibility to be transparent about the choices they have made in implementing the Basel II Framework. Finally, as part of their on and off-site supervision, supervisors will monitor banks' compliance with Pillar 3 and thereby promote consistency.

Moving now to the private sector, I wanted to stress the idea that banks should promote transparency of their real risk profile – rather than just aiming to comply with minimum requirements. Banks do have some discretion in the level of detail that they choose to disclose, they should promote understanding of key decisions they have made that affect their minimum capital requirements.

Accordingly, the granularity with which disclosures are made should promote understanding (rather than masking key information). Banks should promote transparency by providing enough information for investors to understand the risk-return trade-off associated with investing in the bank (or specific product lines), irrespective of whether or not those disclosures are explicitly required by the Basel II rules.

As regards the role of analysts, I am afraid there is no free lunch. To benefit from better understanding the relationship between risk and returns for a given bank, and make comparisons across banks, requires:

(i) Knowledge of Basel II and Pillar 3. Basel II is not simple. It does require a significant amount of effort to understand. But for that, there is a benefit in not only better understanding what drivers will determine minimum regulatory capital requirements, but also the inherent risk of the bank and the quality and effectiveness of its risk management.

(ii) Digging below the headline number. A simple comparison of published capital ratios is only the very start of the process. You need to understand the drivers of that capital ratio. This involves understanding:

- Environmental factors which encompass tax, accounting and legal issues that vary across countries and can impact upon reported capital ratios. International comparisons require an understanding of how these factors impact upon capital requirements.

- Supervisory implementation differences

- Individual bank decisions (e.g. nature of rating systems; options chosen from the Basel II suite)

As a conclusion, to benefit from Pillar 3 you need to do your homework. That is a good thing for you – it ensures high demand for your work. If it were all as easy as comparing headline risk-based capital ratios – would it be necessary to have banking analysts?

To summarize the five main point of my talk today:

1. Pillar 3 will provide much more detailed risk information (risk information is different to accounting information)

2. Don't expect perfect comparability

3. Effective use of Pillar 3 disclosures requires effort by analysts - for that there should be a reward

4. This is an iterative and evolutionary process. It will take time for the whole process to bed down and I expect significant improvements over time.

5. Supervisors have a role to play with regard to the overall architecture of Pillar 3 – but ongoing evolution should be largely driven by interaction between banks and analysts

That concludes the main part of my talk today. Before I give up the floor however, I would like to say a few words about an announcement made by the Basel Committee last week (on January 9) to strengthen implementation of supervisory guidance and standards.

Last week the Basel Committee announced the creation of the Standards Implementation Group, the S.I.G.

This new group will replace the Accord Implementation Group (AIG). The S.I.G. mandate is much broader than the AIG, as it includes implementation of all Basel Committee standards and guidance, not just Basel II implementation. However, Basel II will remain a top priority for the SIG. In this regard the S.I.G. will continue to work on home-host issues; supervisory colleges; and implementation of the three Pillars of Basel II.

Why am I telling you about this group? It has nothing to do with the fact that I am the Chairman of the S.I.G.. It has to do with the reason why the Committee has made this subtle but important change. This relates to the fact that many of the current weaknesses exposed by the financial crisis are the result of inadequate implementation of existing risk management standards and guidance.

The financial crisis has demonstrated the need to follow-up on supervisory guidance and standards to promote consistent implementation by banks and supervisors. Many of the current weaknesses exposed by the financial crisis are the result of inadequate implementation of existing risk management standards and guidance (e.g. Basel Committee guidance on liquidity and stress testing).

Addressing deficiencies in implementation are just as important (if not more important) as addressing deficiencies in policies.

Thank you