

Basel II Pillar 3: Challenges for banks

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Pillar 3, a significant step towards better market reporting

In recent years, policy makers such as the International Accounting Standards Board (IASB) and the Basel Committee on Banking Supervision (Basel) have taken significant steps to improve market reporting with IFRS 7 and Pillar 3 of the revised Framework for International Convergence of Capital Measurement and Capital Standards ('Basel II'), respectively. In particular, Pillar 3's objective is to improve market discipline through effective public disclosure to complement requirements for Pillar 1 and Pillar 2. To that end, Pillar 3 has introduced substantial new public disclosure requirements, which represent a significant increase in the amount of information made publicly available by banks around capital structure, capital adequacy, risk management and risk measurement.

IFRS 7 was effective for reporting periods starting on or after 1 January 2007.

Banks adopting Basel II as of 2007 already had to publish Pillar 3 data. For others, such as most European banks adopting Basel II as of January 2008, Pillar 3 disclosures have to be made for the first time over the year ended 2008. For those which have not started their Pillar 3 process it is worth looking at the lessons learned by the early adopters.

In a nutshell, Pillar 3 disclosures cover the following aspects from both a qualitative and a quantitative standpoint:

- Scope of application of the capital adequacy framework;
- Capital structure and capital adequacy;
- Credit risk (requirements are very extensive for banks adopting the more advanced Internal Ratings-Based, or IRB, approaches);
- Securitisation;
- Market risk;
- Equities;
- Interest rate risk in the banking book; and
- Operational risk (requirements are more onerous for banks adopting the Advanced Measurement Approach, or AMA).

In addition, banks have to provide a qualitative explanation of their approach to the internal capital adequacy assessment process (ICAAP) under Pillar 2. However, unlike IFRS 7, Basel II does not require any specific disclosures on liquidity risk.

It is important to note that the disclosures relating to the capital structure and capital adequacy, as well as those relating to the ICAAP, not only have to be made at the level of the top consolidated entity, but also individually for each 'significant' subsidiary. This can create a sizeable additional burden for internationally active institutions with significant operations in a number of countries.

By nature, Pillar 3 disclosures draw heavily from information already gathered through the Pillar 1 preparation, as much of the data required by Pillar 3 disclosures also has to feed the regulatory reporting on minimum capital requirements under Pillar 1. However, banks should not underestimate the implementation effort associated with the Pillar 3 disclosure process, and perhaps more importantly, they should not overlook the communication strategy implications associated with the publication of this information.

Establishing a strong governance structure early is critical

The first challenge that banks face when preparing for Pillar 3 disclosures is to establish a governance structure around the disclosure process. Due to the multiplicity of organisational units involved, one of the key risks associated

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with the production of Pillar 3 disclosures is the lack of ownership of the entire process, and/or the late involvement of key stakeholders. Typically, successful Pillar 3 implementation projects are sponsored by the CFO and will involve the following organisational units at the very beginning to make sure that all inputs are considered and that responsibilities are defined:

- **Board of directors** (must approve the formal disclosure policy);
- **Finance and accounting** (generally have primary responsibility for financial and regulatory reporting);
- **Risk management** (which would usually own much of the data that needs to be disclosed under Pillar 3);
- **IT** (responsible for the design and maintenance of the data collection solution);
- **Internal/External auditors** (depending on whether the disclosures are included in the financial statements or need to be consistent with data in the financial statements); and
- **External communication/investor relations** (define the overall communication strategy around risk

management and ensure consistency of messages between all aspects of market reporting).

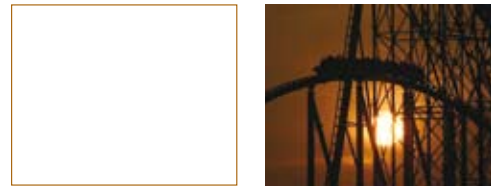
Pillar 3 presents significant data and process challenges

Once the governance structure is established, the next challenge is around data availability and quality. While in most cases roughly 80% of Pillar 3 qualitative and quantitative disclosures should be available from data accumulated for Pillar 1, banks have not always contemplated Pillar 3 requirements when preparing for Pillar 1. Accordingly, data is not always organised in such a way that it can be easily retrieved and organised for public disclosure. Additionally, certain disclosures come from accounting records, such as period-end and average gross credit exposures, changes in the allowance for loan losses, or the amount of impaired loans, to name a few. A potential complication arises where the consolidation circle for accounting disclosures does not coincide with that for which Pillar 3 disclosures are required, for example due to the exclusion of insurance activities in Basel II. A methodical approach to sourcing the data for Pillar 3 disclosures is therefore key to ensure that data gaps are identified and resolved early in the process.

Beyond data availability, data quality is also a major issue that banks have to deal with. Historically, the risk data that was used in the risk management process was for internal use only, and may not have been of 'auditable' quality – after all, data that is 90% or 95% accurate may be fine for risk measurement and management information purposes. We have noticed that the quality of data used in IFRS 7 disclosures has improved significantly already. Taking into account these experiences, we expect that for most banks the quality of other risk management data has to be improved.

Pillar 3 requires that appropriate internal controls over the production of disclosures be in place. Additionally, banks must have an independent validation process. This is a regulatory requirement in certain jurisdictions; hence appropriate independent skilled resources need to be on hand to fulfil this role. It is possible that suitably experienced staff within internal audit could perform this task.

For banks subject to Securities and Exchange Commission (SEC) requirements, Sarbanes-Oxley requirements will also apply to Pillar 3 disclosures if these are made in the financial statements or an SEC filing. Few banks around the world



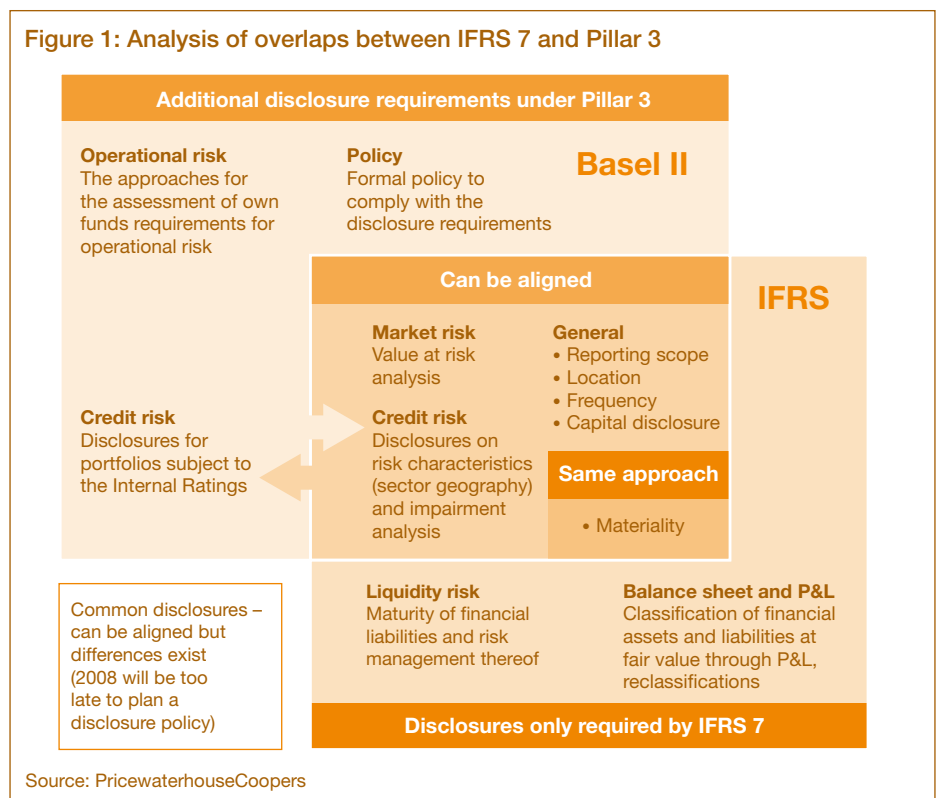
have yet fully managed the interdependencies between Sarbanes-Oxley and Basel II. One would expect that a lot of controls required under Basel II (e.g. model validation process under Pillar 1, governance and oversight process under Pillar 2) will go a long way to fulfilling the Sarbanes-Oxley requirements. However, controls required for Sarbanes-Oxley around spreadsheets and IT applications may not have been fully considered for Basel II purposes.

Banks should establish a coherent disclosure and communication strategy around risk management

This is probably the most strategic issue that banks will need to consider, as Pillar 3 will considerably increase the volume of public disclosure around risk management, in particular in the areas of credit and operational risk as well as Pillar 2. This coincides to some extent with disclosures required under IFRS 7, the IFRS standard that deals with disclosures on financial instruments.

Figure 1 highlights the considerable overlaps between the requirements of IFRS 7 and Pillar 3. In particular, regarding credit and market risk, most of the qualitative disclosures can and should be aligned. Similarly, there is a considerable amount of quantitative

Figure 1: Analysis of overlaps between IFRS 7 and Pillar 3



disclosures that overlap, such as the analyses of credit risk exposures and value-at-risk measures. There are differences, however, between the two disclosure frameworks. For instance, Pillar 3 does not cover liquidity risk and IFRS 7 does not address operational risk.

In order to present a coherent and credible picture to the financial markets, there will need to be consistency between the IFRS risk and capital

management disclosures and the corresponding Pillar 3 presentation. Beyond just IFRS 7, banks will need to review the consistency of Pillar 3 and other risk management disclosures with other public disclosures such as segment reporting. This is key in meeting regulators', analysts' and investors' demands for more consistent and insightful information about risk and capital management, and the results thereof. While a more transparent

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approach to disclosure will likely open banks to the spotlight of scrutiny, it will also certainly work to the benefit of those which can demonstrate clearly their strengths in that area.

Experience suggests that risk management and accounting teams do not always communicate effectively. In the context of Pillar 3 and IFRS 7 implementation, failure to do so will potentially increase the cost of complying with these requirements, and worse still the information presented could be inconsistent. Whatever the source, disclosures should be consistent and reflect the views of management. It is therefore essential that a uniform message be delivered from the CEO's address to shareholders all the way to the accounting footnotes, along with Pillar 3 disclosures. This will require a concerted effort between all parties involved, which further emphasises the need for a strong governance structure as highlighted above.

A further issue that needs to be considered by the investor relations department is that the level of sophistication that the bank has been able to achieve under Basel II will be immediately visible. Under Basel I, all banks were subject to the same set of rules, and the only numbers of interest to outside parties were the capital adequacy ratios themselves. Basel II allows a range of different

approaches to be adopted, with increasing levels of sophistication. Under the Pillar 3 disclosures, it will be apparent which approach an individual bank has adopted. How will investors and analysts react if, say, Bank A has adopted only the more basic approaches while peer banks have adopted more sophisticated approaches? Does this say something about the level of sophistication and/or data quality in Bank A relative to its peers?

Also, Pillar 3 significantly increases the level of detail that is disclosed and that can be used by investors, analysts and rating institutes to compare and analyse each bank's risks. For instance, Pillar 3 disclosures will provide an opportunity for analysts and others to benchmark key data (e.g. probabilities of default (PDs)) for each bank against its peer group. This will inevitably pose some questions about asset quality, provisioning, the robustness of risk management practices and/or the reliability of data disclosed.

The workload associated with explaining the increasingly complex Basel II numbers should also not be underestimated, especially in the early years, where banks may also be operating a mixture of approaches during a transition period to the more advanced levels. Investors and analysts may be inclined to draw conclusions based on incomplete understanding of the numbers. For

instance, for banks adopting the IRB approaches there is a strong element of pro-cyclicality in the risk-weighted assets calculation – in an economic downturn, one would expect customers to be downgraded and/or probabilities of default to increase. This would result in an increase in risk-weighted assets relative to the balance sheet volumes and place pressure on capital adequacy ratios. It may be difficult to raise 'top-up' capital in such economic circumstances.

Furthermore, the Tier 1 capital and capital adequacy ratio goals, which under the current rules have been comparable between banks, will now depend on the Basel II approach that has been chosen. For instance, how do you compare a Tier 1 ratio goal of 7% for a standardised approach bank versus an IRB bank?

A similar issue with respect to comparability arises where national regulators have chosen to deviate from the basic Basel II rules, particularly where the national rules are more conservative. This is, for example, the case in Australia, where the regulator has imposed a 20% loss given default (LGD) floor for residential real estate secured exposures (above the 10% within the Basel framework) and requires capital for interest rate risk in the banking book to be part of Pillar 1 minimum capital requirements. As a result Australian banks will tend to show



lower capital adequacy ratios compared to international peers, which could be misinterpreted.

What are the steps in the Pillar 3 implementation process?

The effort associated with the implementation of Pillar 3 disclosures should not be underestimated. Based on our insights the key next steps banks should take to approach this project are the following:

- Set up a separate project structure under a strong sponsor (e.g. chief financial officer);
- Establish key Pillar 3 policy decisions, such as the location of disclosures, their frequency, the scope, definition of materiality, etc. Dividing the information which should be on the audited annual report from the information that should be on other mediums such as the website can be a great challenge;
- Determine at what level other than the top consolidated entity Pillar 3 disclosures have to be made;
- Perform an analysis of what information will be needed in addition to Pillar 1 information;
- Perform an analysis of what the other internal and external requirements for disclosure are, in addition to the supervisory requirements under Basel II;
- Perform an analysis of the overlaps between Pillar 3 disclosures and other publicly disclosed risk and capital management information (e.g. IFRS 7);
- Design disclosure templates that meet the requirements of Pillar 3 and other public disclosure requirements;
- Source required data from existing systems and identify data gaps;
- Define an IT architecture for data gathering, aggregation and reporting;
- Establish a validation process around Pillar 3 disclosures;
- Define a communication strategy and involve the investor relations team at an early stage; and
- Produce disclosures.