Basel II – Pillar 3

The objective of Basel II Pillar 3 is to improve market discipline through effective public disclosure to complement requirements under Pillar 1 and Pillar 2. To that end, Pillar 3 introduces substantial new public disclosure requirements, and will represent a significant increase in the amount of information made publicly available by banks and investment firms around capital structure, capital adequacy, risk management and risk measurement. Máiréad Devine, Director, PricewaterhouseCoopers looks at the implications of these new requirements.

In recent years, there has been a concerted effort in a number of policy contexts to increase and enhance the amount of information institutions reveal in their public statements. While this drive has partly been a reactionary response to a number of both bank and non¬bank incidents of significant misreporting of balance sheet positions, it also represents a proactive initiative by policy makers to strengthen the role of market discipline in the prudential supervision of banks.

The concept of market discipline can be summed up in the phrase ‘accountability through transparency’. Accountability is the expectation that a bank’s management acts in the best interests of outside stakeholders, principally the current and prospective holders of its equity and debt (collectively represented by equity analysts and rating agencies, among others). Transparency is the expectation that a bank discloses sufficient information so as to allow these stakeholders to make informed judgements as to whether the bank is acting in their best interests. If the bank is not acting in their best interests – for example by taking excessive risk relative to an expected return – these stakeholders can respond accordingly. When they do, and the cost of the bank’s capital or debt increases, pressure will be brought to bear on the bank’s management to adjust their risk-taking behaviour. In this way, the market provides a discipline on banks’ risk-taking activities which acts as a form of self-regulation. For the market discipline mechanism to operate effectively, it is thus imperative that stakeholders receive frequent, relevant and meaningful information regarding the risk profile and management of banks, and for the disclosure of such information to be both mandatory and reasonably consistent across banks and jurisdictions.

The Basel Committee on Banking Supervision (Basel) has sought to harness market discipline through Pillar 3 of its new capital adequacy framework (Basel II). The European Commission has translated the Basel Pillar 3 requirements into the Capital Requirements Directive (CRD) to which all EEA banks are subject.1 The disclosure requirements introduced by Pillar 3 are substantial and for most institutions will represent a significant increase in the amount of information they make publicly available. This will be particularly true for banks seeking to avail of the use of the more advanced approaches to credit, market and operational risk under Pillar 1, where extensive disclosure is an integral part of the qualifying criteria for these approaches.

Banks will be required to make their first disclosures under Pillar 3 anywhere between 2007 and 2009. The precise date depends upon when they themselves transition to Basel 2 and also on how their national supervisor chooses to implement the requirements. While setting out high-level requirements, Pillar 3 provides banks with significant latitude in terms of how these requirements are met. Banks therefore need to be thinking both strategically and operationally in terms of how they are going to meet the challenges of Pillar 3 – what is involved, what choices do they have and what challenges are they likely to face?

REQUIREMENTS AND CONSIDERATIONS

A key requirement of Pillar 3 is the need for banks to produce a formal disclosure policy, addressing their approach to determining what disclosures they will make and the internal controls they have in place over the disclosure processes. Banks therefore need to have a comprehensive, documented strategy for disclosure going forward. This policy document, at a minimum, should address the frequency of disclosures, location and verification process (below). The Financial Regulator has stipulated that banks in Ireland must have a disclosure policy statement in place when they implement the CRD – this can be no later than 1 January 2008.

Nature of Disclosures
The Pillar 3 disclosures can be broadly divided into the following categories:
- capital structure,
- capital adequacy, and
- risk.

Both qualitative disclosures on risk management processes and procedures and quantitative disclosures on actual risk exposures are addressed. From a data perspective the detail required is highly prescriptive and often very technical. By far the most onerous

disclosures are in respect of credit risk, and therein a vast quantity of data is to be disclosed on the parameters – both ex ante, and ex post- of models employed in the advanced approaches. Information on operational risk, interest rate risk in the banking book, market risk, and equity risk in the banking book is also required.

Frequency
If disclosures are to be relevant, then they should also be timely. The disclosures in Pillar 3 will be required on an annual basis. Institutions are, however, expected to determine whether more frequent disclosure of certain information types is appropriate (for example, volatile information which is likely to become obsolete).

Materiality, Proprietary and Confidential Information
An important facet of a framework for disclosure is that information must be comparable across institutions. While this has to be balanced against the need for firm-specific information, a certain degree of harmonisation of disclosure requirements is necessary to ensure comparability across institutions (both within and across jurisdictions) and over time.

However, there is certain information that banks should not be expected to disclose. Where the disclosure of certain information would undermine an entity's competitive position, and reduce the value of an entity's investment in certain products, then such information is regarded as proprietary. Similarly, certain information regarding counterparties will be confidential. Where the disclosure of proprietary or confidential information could jeopardise the position of the bank then, subject to the bank making general disclosures on the subject matter and an explanation as to why information has been omitted, this information need not be disclosed.

All 'material' information should be disclosed. Information is classified as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. Thus, banks have the discretion not to disclose information that is regarded as immaterial.

Location and Verification Process
Given the sheer volume of disclosures required under Pillar 3, particularly for those banks using advanced methodologies for credit risk, it would not necessarily be practicable for banks to include the information requirements under Pillar 3 as part of the financial statements. This is recognised to the extent that the location of the disclosures is not mandated, other than that they should ideally be located together, and reference should be made in the financial statements as to where the information is located.

The disclosures under Pillar 3 must be validated. This does not however constitute a requirement that they be subject to an external audit. Precisely how this validation process will operate will have to be decided by banks.

CHALLENGES FOR FIRMS

In preparing for the CRD, the industry has tended to underestimate the potential impact of Pillar 3 and the associated implementation efforts, perhaps hoping that the new requirements will be subsumed within the proposed new international financial reporting standard on disclosures in respect of financial instruments ('IFRS 7'). This has not been the case. The time for lobbying against the requirements has long since passed and banks need urgently to turn their attention to implementation. In Ireland, most banks are having to gear up around the Financial Regulator's requirements of having a disclosure policy in place before the end of 2007 and making the first disclosure under this policy within 12 months of this date (i.e. end 2008).

The Pillar 3 disclosures look deceptively compact as written in the CRD. Banks, however, are advised to examine the requirements in detail to fully grasp the breadth, depth and ultimately the volume of information they will have to produce. It is also often assumed that the data requirements will be sourced entirely from the Pillar 1 data architecture. While this is true for a significant number of the disclosures, there are certain quantitative disclosures which will not be utilised as part of the capital adequacy calculations and which will thus have to be sourced uniquely for Pillar 3. Unless addressed early in the implementation process the sourcing of this data could be highly problematic.

As part of their overall CRD implementation plans, banks should ensure that there is a cohesive project plan for the implementation of Pillar 3. Given that Pillar 3 will involve the collation of data from various sources, it is imperative that the process is properly managed with clear milestones, and identification of relevant stakeholders. A key challenge in this regard is ensuring appropriate allocation of responsibility and ownership for Pillar 3. While much of the information to be disclosed is located within the risk management function, financial disclosures more generally will rest with the finance function. It is thus

not immediately apparent where the responsibility for Pillar 3 should lie; the establishment of clear and documented responsibilities for Pillar 3 is a critical first step. This is particularly important where banks also have implementation plans underway for IFRS (see below), where the overlap with other initiatives such as IFRS and Sarbanes-Oxley is an additional challenge. Furthermore a process should be put in place to ensure Board and senior management awareness of the Pillar 3 disclosure requirements, and the potential impact of the new disclosures.

SYNERGIES WITH IFRS

The IASB has introduced a new accounting standard on disclosures pertaining to financial instruments, IFRS 7. A significant challenge for firms has been managing the interaction between Basel II/CRD and IFRS, where disclosure is one key area of overlap. This has often been exacerbated by the fact that the 'ownership' of the Basel II and IFRS work-streams often rests in different parts of the organisation, for example, in finance and risk, thus lessening the likelihood of communication and meaningful endeavours to identify conflicts and synergies.

As noted, Pillar 3 is intended to facilitate the prudential supervision of banks, through a disclosure framework aimed at enhancing the operation of market discipline in the financial system. Information on capital structure, capital adequacy, risk exposures and risk management processes is thus key in this regard. IFRS, on the other hand, has the purpose of providing information to the user to understand the financial position and financial performance of a firm, and because the IASB's scope allows it only to consider disclosures to be included within the financial statements, the disclosures in the new standard will all have to be subject to the remit of external audit, with further cost implications. The two frameworks are not incompatible but the differing objectives will ultimately result in a less than perfect overlap.

The initial step for firms with respect to the Pillar 3 and IFRS 7 challenge is to identify those areas where quantitative disclosures required under IFRS are similar to those under Pillar 3, and vice versa, and where qualitative disclosures can be aligned. The degree of identical overlap between the two sets of disclosures is very limited where information is often related but not exact. It is imperative that institutions ensure that a clear and consistent message is presented externally in those areas which address corresponding themes. Where necessary, reconciliations may need to be disclosed to avoid confusion or misleading signals being communicated.

CONCLUSION

Many banks see Pillar 3 as a threat rather than an opportunity; not unlike Pillar 2, as a price extracted by the regulators for the potential gains under Pillar 1. But in truth there is a lot for banks to gain under Pillar 3 if it is approached strategically and thoroughly. Banks with a strong risk-return profile and robust risk management can use Pillar 3 as a lever to differentiate themselves from the pack and in turn reduce their cost of capital and/or debt. No clearer case for Pillar 3 can be made than the current unease in financial markets brought about by the sub-prime woes in the US. All banks worldwide have felt the effect of this because the market has found it difficult to differentiate between those directly affected, those indirectly affected, and those which are isolated from it. The majority of banks would be better off had they made extensive risk disclosures. Those banks that are first to recognise this, and that engage in a dialogue with the ultimate users of the information they disclose, will be the ones that stand to gain the most.

1 The CRD, and thus Pillar 3, applies to both banks and investment firms. For simplicity we refer singularly to banks here.