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Editor’s comments
Welcome to the December 2008 edition of The Journal. These continue to be very interesting times for the financial services sector. The credit crisis is very much still with us and the implications are running wider and deeper than anyone would have predicted 18 months ago. In this edition, we have brought together a range of articles focusing not only on some of the continuing challenges of the credit crunch but also on some of the other topical issues facing global organisations.

Even with the ongoing credit crunch, climate change and its effects are never far from the headlines and now more and more companies are beginning to factor in carbon and climate change considerations into their investment decisions and financial decision making. In our opening article, entitled ‘Carbon: The new financial frontier’ Richard Gledhill, Alan McGill and Shami Nissan give an overview of the Carbon Disclosure Project’s Global 500 report and highlight the key findings for the financial services sector.

In our next article, ‘Liquidity risk management’, Richard Barfield and Shyam Venkat discuss how liquidity risk is now firmly back on the risk agenda despite being largely an invisible risk for many firms in recent years. Looking ahead, companies need to develop a clear strategy for liquidity risk management and many leading banks are getting their strategies into shape now rather than run the risk of being mandated to by the regulators.

With the ongoing market turmoil the link between reward and risk has come under ever more scrutiny by shareholders, regulators and the media. Even management teams themselves have admitted that compensations systems in financial services are in need of reform. In our next article, ‘Reward: A new paradigm?’ Tom Gosling and Jon Terry highlight the current issues and possible future reforms to compensation for the industry.

Similarly, valuations and their associated controls have also come under significant recent scrutiny. Doug Summa, Fleur Meijs and Arjan Udding discuss some of the key challenges around valuation governance as a consequence of the recent market developments in the article ‘Valuation control in turbulent times: Challenges to the operating model’.

In our final article, ‘Basel II Pillar 3: Challenges for banks’, Christophe Cadiou and Monika Mars highlight the key issues under Pillar 3 and the challenges banks may have in meeting these disclosure obligations as well as highlighting the key next steps banks should take to tackle these issues.

We hope you find this edition of The Journal of interest. After 6 years in its current format, your next edition of The Journal will be in a new format that will allow us to continue to bring you the highest quality articles while at the same time ensuring we address the key topical industry issues as they arise.

I therefore would like to take this opportunity to thank our Editor, James Hewer, for all his hard work over the last 3 years. While James will continue on the Editorial panel, the acting editor for each future edition will rotate.

Please do continue to provide us with feedback on both the content and topics you would like to see addressed in future editions. Online copies of this edition and other PricewaterhouseCoopers’ publications can be found at www.pwc.com/banking and www.pwc.com/publications.

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1 ‘PricewaterhouseCoopers’ refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.
Carbon: The new financial frontier
It is often said that a business can only manage what it measures. Since 2000, the Carbon Disclosure Project (CDP)\(^1\) has, on behalf of institutional investors, challenged the world’s largest companies to measure and report their carbon emissions, integrating the long-term value and cost of climate change into their assessment of the financial health and future prospects of their business.

Corporations’ ability and willingness to monitor and report these activities and issues reflects the inexorable rise of climate change from debate at the fringes of society to the boardroom agenda. The effects of climate change may include physical impacts on assets, changing market dynamics for goods and services, escalating regulation and greater scrutiny from an increasingly sophisticated range of stakeholders. Investors want to know how companies are futureproofing themselves against these issues, whilst maximising the opportunities they present.

CDP’s sixth and most recent request for information (CDP6) was sent to more than 3,000 of the world’s largest corporations requesting information on greenhouse gas emissions, the potential risks and opportunities climate change presents and strategies for managing those risks and opportunities. The request was backed by 385 leading institutional investors representing more than US$57 trillion of funds under management. The corporations’ responses and reports assessing the results of these were published in more than 20 countries around the world during September/October 2008 and are freely available at www.cdproject.net.

The logic for CDP is simple: addressing the climate change challenge depends on a dialogue between shareholders and corporations, supported by high-quality information. Companies need to articulate their position in a coherent way to an increasingly sophisticated set of stakeholders.

PricewaterhouseCoopers (UK), CDP’s global adviser, has analysed the responses from the 500 largest corporations in the FTSE Global Equity Index Series, the ‘Global 500’. As of March 2008, the market capitalisation of these companies was US$22 trillion. This article provides a brief overview of CDP’s Global 500 Report, and focuses on the key findings pertaining to the financial services sector.

**CDP Global 500: Consistent growth**

CDP is the largest investor coalition in the world and remains the world’s leading proponent of climate change awareness and carbon disclosure. Since its inception, CDP has grown considerably, both in terms of the number of institutional investors which back the disclosure request (from 35 to 385) and the response rate of companies (from 44% to 77%).

As shown in Figure 1 overleaf, CDP6 achieved an impressive overall response rate of 77% – consistent with the record level achieved in CDP5, despite deteriorating economic conditions in many countries in the world and substantial changes in the composition of the Global 500. European and North American companies continue to set the pace, with Asian Global 500 companies lagging.

**Key drivers for action**

Our analysis has found that there are a number of key drivers for action which are raising the significance of carbon and the need for companies to consider carbon as a strategic issue:

- **The impact of uncertainty** – although there is now a broad consensus on climate science, the implications for corporate value are less certain. For some CDP6 respondents, this translates into a ‘wait and see’ strategy to see how peers are responding and how the regulatory environment is evolving. Others clearly feel that late starters risk missing out on opportunities.

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\(^1\) ‘Carbon Disclosure Project’ and ‘CDP’ refers to Carbon Disclosure Project, a United Kingdom company limited by guarantee, registered as a United Kingdom charity number 1122330.
Regulation remains a key issue – with more countries and regions now contemplating emissions trading schemes for carbon-intensive sectors, regulation featured frequently as a key risk factor. Companies are looking for greater visibility on climate policy and on carbon prices, and many also mentioned the lack of harmonisation on regulatory issues. A commitment to a long term, global, cap-and-trade scheme at the UN climate talks in Copenhagen next year would clearly help business to plan for the transition to a low-carbon economy.

Increasing consumer awareness – consumer attitudes are featuring increasingly as a driver of risks and opportunities in the B2C sectors. However, carbon disclosure to customers is still very much in its infancy. Some corporations are exploring carbon labelling, but there is little clarity on what information is relevant or whether this actually impacts upon consumer choice.

More focus on the supply chain – retailers such as Wal-Mart, Tesco and Carrefour noted that they were devoting significant resources to investigating supply chain emissions, possibly motivated as much by cost-savings and reputational benefits as by their wider environmental impact.

The financial services sector

There are 121 financial services companies included in the Global 500, of which 95 responded to the information request. Relative to other sectors classified as ‘non-intensive’, the financial services sector achieved the joint highest scoring. The sector’s relatively strong performance is a reflection of (i) its large exposure to reputational risk, (ii) its long track record of sustainability reporting generally and (iii) its need to understand the risks and opportunities of the businesses in which it invests.

An analysis of results from companies in the financial services sector demonstrates that the sector is particularly strong in disclosing risks and opportunities, i.e. their identification, management and assessment of business impact. This is likely to be a result of the industry needing to integrate climate change risks and opportunities into its day-to-day investment, lending and contract decisions to run a successful and sustainable business (See Figure 2).
The financial services sector disclosures suggested that the three key risks for the sector at the time were:

- **Reputation** – as a result of growing consumer awareness;
- **Credit-worthiness** – of the businesses in its investment portfolio; and
- **Increased energy costs** – as a result of the increased cost of compliance of utilities companies.

Climate change impacts on the companies that constitute the sector’s investment and loan portfolios, and the subsequent credit and other risks are a large and complex area for the sector to evaluate. This is captured in AXA’s response: ‘In terms of investment policy, companies which are ill-prepared for more stringent environmental regulation may face unexpected new expenses and a decreasing ability to sustain their returns and share price, thus decreasing their value in AXA’s investments portfolios.’ Mitigating these risks, for example by using positive selection criteria and exerting influence on the portfolio, could reduce its potential to negatively impact the investor’s profitability.

The level of risk management undertaken in relation to climate change varies significantly throughout the sector. Some companies stated that they do not consider themselves to be exposed to regulatory, physical or general risks, e.g. Aegon and AFLAC, though they do appear to consider risks in relation to their product portfolios. Other companies have integrated climate change considerations into business continuity plans as well as forging links to scientific and academic institutions and introducing climate change investment and lending screening procedures (e.g. American Express, AXA and Canadian Imperial Bank of Commerce).

In addition to this a significant proportion of the sector now factors in carbon and climate change considerations into its investment decisions and financial decision making, as can be seen from ANZ Bank’s response: ‘Future carbon prices and potential carbon credits are factored into our financial decision-making processes where possible.’

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Sir Tom McKillop, Chairman, Royal Bank of Scotland Group, commented: ‘The specialist focus of the CDP provides a suitably rigorous structure for an overview of a company’s response to climate change.’

Each sub-sector is seeing opportunities arising from climate change which are specific to its area of business expertise. The insurance sector has seen opportunities in the areas of managing the risk of carbon credit projects and providing new products to insure against extreme weather events. The banking sector has seen opportunities arising from participation in the trading of carbon and renewables certificates and providing specialist ‘green products’ for responsible investors. The response from Allianz shows just how much potential there is for new product and service innovation in the change to a low-carbon economy: ‘Regulatory changes to combat climate change are providing a huge portfolio of opportunities.’ Similarly, Merrill Lynch & Co commented: ‘We believe that the market for alternative energy, clean technology and carbon trading will continue to grow exponentially.’

**Carbon disclosure leadership index**

The Carbon Disclosure Leadership Index (CDLI) identifies the top scoring companies within each sector, and provides a valuable perspective on the range and quality of responses to CDP’s questionnaire (the CDLI score is not a metric of a company’s performance per se as it does not take into account emissions levels or reduction achievements).

Financial services companies have traditionally featured strongly in the CDLI, reflecting the commitment of the sector to carbon disclosure and the strategic importance of climate change to the sector, notwithstanding the relatively low level of its own direct emissions.

**Conclusions**

Given their level of exposure to the public and the general consumer most of the companies in the sector, in particular the banks, have taken great steps to ensure they are seen to be ‘green’. These steps have to date included providing products for the environmentally conscious.

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**Figure 3: Carbon disclosure leadership index – financial services sector**

<table>
<thead>
<tr>
<th>Company</th>
<th>CDLI Score</th>
</tr>
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<tbody>
<tr>
<td>Barclays</td>
<td>98</td>
</tr>
<tr>
<td>Merrill Lynch &amp; Co</td>
<td>98</td>
</tr>
<tr>
<td>Munich Re</td>
<td>98</td>
</tr>
<tr>
<td>National Australia Bank</td>
<td>98</td>
</tr>
<tr>
<td>Australia and New Zealand Banking Group</td>
<td>97</td>
</tr>
<tr>
<td>Citigroup</td>
<td>97</td>
</tr>
<tr>
<td>Lloyds TSB</td>
<td>97</td>
</tr>
<tr>
<td>Royal Bank of Canada</td>
<td>97</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>97</td>
</tr>
<tr>
<td>HBOS</td>
<td>95</td>
</tr>
<tr>
<td>Westpac</td>
<td>95</td>
</tr>
<tr>
<td>Royal Bank of Scotland Group</td>
<td>94</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>94</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>92</td>
</tr>
<tr>
<td>Allianz SE</td>
<td>91</td>
</tr>
<tr>
<td>HSBC Holdings</td>
<td>91</td>
</tr>
<tr>
<td>Bank of Montreal</td>
<td>90</td>
</tr>
<tr>
<td>Hartford Financial Services</td>
<td>90</td>
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</tbody>
</table>

Source: Carbon Disclosure Project 2008 – Global 500
Consumer, reducing energy use and offsetting emissions. As well as saving energy costs, these schemes have been reported as providing the leading institutions with good reputations and hence potential customer appeal.

The disclosures from the financial services sector show that its greatest risk from climate change and its greatest opportunity to reduce the advance of global warming is through its investment and lending portfolios and other customer exposures. The deep and wide risks that a financial institution is exposed to through its portfolio must be increasingly understood and made transparent to assure investors that climate change poses a managed and controlled risk to their investment. In conjunction with this, financial institutions have the opportunity to influence their portfolio to reduce emissions, provide ‘solution’ products and adapt to the changing climate.

Financial services sector company highlights:*

- Top disclosers by CDLI score: ANZ Bank, Barclays, Merrill Lynch, Munich Re, National Australia Bank

Key sector metrics

- Number of companies in the Global 500 in sector: 121
- Number of companies responding in sector*: 91 (75% – ranked =5th overall, =2nd out of non-carbon intensive)
- Number of companies disclosing publicly: 76 (83% of respondents)
- Sector average CDLI score: 70 (ranked =1st out of non-carbon intensive)
- Range of scores: 7 lowest – 98 highest
- Percentage of respondents disclosing emissions: Scope 1: 64%, Scope 2: 65%, Scope 3: 56%
- Most common metric used for measuring emissions intensity – per employee and per square metre

* Companies listed include non-public responses. Names are listed alphabetically within categories.

# The information in this box is based on the final number of respondents to CDP as of 31 July 2008. However, for time reasons the cut-off date for the responses received in the data and charts in the rest of the section was 1 July 2008, and hence these may differ slightly from this figure.
Liquidity risk management
It is not listed on any exchange. Nor is it a line item on any financial institution’s balance sheet. Nonetheless, confidence is the financial system’s and every financial institution’s most valuable asset.

The financial markets cannot hope to recover until confidence is restored. Banks need to recover their faith in each other and rebuild their reputations across their stakeholder base. They must also regain the trust of the regulators.

For that to happen, banks must achieve two things. First, they will have to show that they have learned lessons from the liquidity crunch. Second, they will have to demonstrate that they are putting those lessons to good use. Simply going through the motions will not suffice: banks will have to prove that they are genuinely effecting change.

In our view, this should be done against a clear strategy for liquidity risk management. This requires taking a longer-term perspective, detached from the day-to-day firefighting and conference calls that are currently consuming the days of most treasurers.

**Invisible risk**

The collapses of Northern Rock and Bear Stearns prove that profitability and capital are no defence against liquidity risk. Both made profits in the quarter before they disappeared. Both were well-capitalised businesses. And yet, as a result of their failure to deal with their liquidity risk issues, they were simply swept away.

Of course, Northern Rock and Bear Stearns were not the only banks with their minds elsewhere. The fact is, no one talked much about liquidity risk until last year. Although the regulators may have monitored banks’ management of the issue, they rarely raised serious challenges. As a result, liquidity was largely an invisible risk for many firms.

Risk is managed in silos in many institutions. It is typically split into categories – such as liquidity risk, credit risk, market risk and operational risk – each of which is seen as separate and distinct. Recent events have shown, however, that different types of risk can and do impact on each other. In fact, during times of financial crisis, risks have repeatedly shown a tendency to transform from one type to another with breathtaking speed. We have seen, for example, how mistrust of asset values due to credit default risk can generate liquidity risk. So, going forward, banks will need to place greater emphasis on developing an integrated view of risk across all the risk types.

Asset and Liability Committees (ALCOs) are set to play a pivotal role. Their challenge will be to build a comprehensive, joined-up perspective of their institutions’ asset and liability risk.

To achieve this, ALCOs will need to ensure that fundamental challenges are addressed. Are relevant roles and responsibilities clearly defined and understood? Are management information systems functioning as they should be? In particular, are those systems operating on a ‘real time’ basis that enables up-to-date information to be provided at the right time? Are the interrelationships between market, credit and liquidity risk understood and monitored? As ever, quality rather than quantity is the critical factor, so Key Performance Indicators and Key Risk Indicators need to be in place to allow managers to cut through the mountains of data to the critical facts. Without these, early insight and timely action cannot be achieved.

**Diversified funding sources**

The nationalisation of Northern Rock underlined the need for banks to diversify their funding sources. A sizeable bank that was adequately capitalised, Northern Rock came unstuck as a result of its excessive reliance on the wholesale money market to fund its business.
Liquidity risk management continued

Following a significant fall in that market’s liquidity, Northern Rock was not in a position to meet its payment obligations as they fell due.

The tenor of banks’ funding also needs to be diversified. Banks should stagger their sources of lending to avoid having to make too many debt repayments at any one time. This is easy to say but, when term funding has virtually disappeared, it is difficult to address if the mitigants are not already in place.

Inevitably, utilising a multiplicity of sources will drive up cost. However, as the case of Northern Rock proves, a failure to diversify may ultimately result in a far higher price being paid. Moreover, by using a wider range of lending sources – and by being transparent about those sources – banks can help regenerate confidence.

Risk appetite

The new economic landscape presents some huge challenges. Deposit rate variability has squeezed – and, in some cases, destroyed – net interest margins. While funding can still be found, it is only available for shorter periods and at a higher price.

Time periods are now severely compressed. Until recently, long-term lending might involve periods of five or even ten years. Today, when people discuss long-term money market, they may not be talking about anything more than a month, although tenors on wholesale funding are starting to lengthen for good names.

Lending timescales will, of course, eventually lengthen. When they do, banks will need to think hard about the extent to which they wish to lock in longer-term funding. Each will have to come to its own conclusion based on its appetite for risk and, in particular, the balance it wishes to strike between cost and certainty.

This is never an easy task. By receiving capital injections from sovereign wealth funds and portfolio investors some institutions have achieved certainty of funding without requiring government support. However, some observers have suggested that these deals might ultimately prove too expensive. Before the crisis, critics had accused other banks of excessive caution or the crime of using ‘lazy capital’. These banks may well feel that their conservative approaches to liquidity risk and high capital ratios risk have now proved more than justified.

The events of the last 12-18 months will no doubt cause all banks to review risk appetite. As they do so, they should consider how they want to express that appetite in relation to liquidity risk and funding risk. In the past, banks have been reluctant to be explicit, with the result that there was always leeway for individuals to exercise their own judgement. The credit crisis has shown that banks need to define risk appetite in much tighter terms.

A new era

Liquidity risk management is entering a new – and much more demanding – era. In the last few months, papers by the Committee of European Banking Supervisors, the Basel Committee on Banking Supervision and the International Institute of Finance have set high hurdles in terms of principles and recommendations. The UK Financial Services Authority (FSA), meanwhile, will soon be publishing its proposals for reinvigorating its liquidity risk regulations.

Instead of waiting to be told what to do by the regulators, leading banks are getting into shape now. By the time the regulator comes around, these banks will be ready to demonstrate that their senior management has a clear understanding of and a genuine involvement with their firm’s liquidity risk management. As a result of the collapse of Lehman Brothers and the demise of other storied financial houses that have since been absorbed by stronger institutions, banks will need
to be clear on the liquidity implications of their firms’ legal structures. Regulators are very likely to place greater emphasis on local liquidity risk positions and place less faith in group support. Banks should review their liquidity policy statements and contingency funding plan (see Figure 1) and should challenge the assumptions that underpin their behavioural modelling, their mismatch guidelines and their expectations of parental support.

Since they are a vital part of the liquidity risk management toolkit, banks should pay greater attention to their stress tests (see Figure 2). Regulators will want to see that these have been properly developed and well executed and that senior management has been fully involved. To avoid any possibility of misinterpretation, banks should take great care over how they communicate the results of stress tests to regulators.

In assessing the required improvements to their liquidity risk management approach and to develop their strategic view, banks should undertake a gap analysis against best practice. This analysis should evaluate liquidity risk management in the following areas – risk definition; governance and oversight; liquidity management; measurement and reporting; stress testing; contingency funding plan; and public disclosure.

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**Figure 1: Credible contingency funding plan**

- Adequate management and reporting framework
  - Act upon the early warning signs
  - Avoid or mitigate possible crises promptly
- Clearly documented management action plan
  - Alternative sources of liquidity
  - Trigger levels for action
- Evaluate a wide range of possible scenarios
- Communication plan
  - Internal and external communications
  - Prevent further escalation or contagion
- Regular sources of liquidity supplemented with contingent sources
- Board approved and wider management involved

Source: PricewaterhouseCoopers

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**Figure 2: Liquidity stress-testing approach – example**

**Identify liquidity risk drivers**
- Erosion in value of liquid assets
- Additional collateral requirements
- Evaporation of funding
- Withdrawal of deposits etc.

**Design stress scenarios (and probabilities)**
- **External scenarios:** Emerging markets crisis, systemic shock in main centres of business, market risk
- **Internal scenarios:** Operational risk, ratings downgrade
- **Ad-hoc scenarios:** e.g. country/industry specific

**Model stress tests**

**Step 1:** Quantify liquidity outflows in all scenarios for each risk driver

**Step 2:** Identify cash inflows to mitigate liquidity shortfalls identified

**Step 3:** Determine net liquidity position under each scenario

Source: PricewaterhouseCoopers
Communication will be key

Banks should recognise that they need to think long and hard about what they want to say and how they are going to say it. In particular, how much and what information do they want to disclose?

Greater transparency and enhanced communications will be central to strengthening trust. In the past, there has been considerable disparity in the levels of banks’ liquidity risk disclosures. Figure 3 provides a simple indicator of the extent that banks report liquidity risk relative to other risks and risk disclosures in total. For example, HSBC devotes 97 pages in its 2007 annual report to risk and 6 of these to liquidity risk. As one can see the range of disclosure varies considerably for these well regarded institutions. Now that liquidity risk is under the spotlight, banks are likely to need to provide a much greater volume of information. Moreover, that information will need to be more detailed and specific.

Banks will inevitably be reluctant to provide information that might place them at a competitive disadvantage or make them vulnerable to the actions of predatory market participants such as certain hedge funds. For example, no bank will wish to disclose its internal view of the liquidity buffers that it believes it needs.

Under Pillar 2 of Basel II regulators might choose to impose higher capital requirements on banks whose liquidity risk management fails to match the required standards. Such a move would at the very least provide such banks with a strong financial incentive to get their houses in order.

Back to the future

The financial world has already begun to change in response to the seismic events of the last few months. We have seen, for example, leverage levels drop dramatically and capital ratios grow significantly. While it seems inevitable that banks will become a lot smaller and less complex than they have been, little else is certain.

Now is a good time to refocus on fundamentals. By proving to the external world that they truly understand their businesses and the potential risks to those businesses, banks can show that they run themselves prudently. If they can do that, they will have taken a huge step towards rebuilding confidence and restoring the health of the financial system.

Figure 3: Liquidity disclosure ‘page test’

<table>
<thead>
<tr>
<th></th>
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<th>Risk</th>
<th>Credit</th>
<th>Market</th>
<th>Liquidity</th>
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<td>Morgan Stanley (10-k)</td>
<td>199</td>
<td>38</td>
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Source: 2007 Annual Reports, PricewaterhouseCoopers analysis.
Reward: A new paradigm?
Introduction

Shareholders, regulators, the media, even management teams themselves, say compensation systems in financial services are in need of reform. Current practices, it is observed, are not only too short-term oriented but also fail to adequately link rewards with risks. But even though executives believe change is essential, their range of available action is relatively limited: history shows that unless the industry moves as one, talent will move to where reform is least evident.

It is an era where the earnings of many firms are distressed, not to mention the prevalence of layoffs and restructurings. But think back to just a few years ago. Back then an extended bull market created pressure to attract and retain top talent. So banks and other financial services firms began to rely increasingly not only on higher pay levels in general but also on short-term-oriented ‘eat what you kill’ incentive structures.

Fast forward to today, where a broad range of market, political and regulatory forces are including such practices as one of the many factors that have led to the current market downturn. Commentators are criticising financial services firms for incentive practices that they say encourage undesirable behaviours ranging from excessive risk taking to over-emphasis on short-term results. Bonuses still being paid to executives at underperforming or distressed companies are viewed with particular enmity.

None of this can be proven definitively and there are many voices to the contrary. Nonetheless, what is known for certain is that, largely in response to these pressures, compensation practices are receiving increased scrutiny across the financial services industry.

The outcry for reform

Though particularly vocal currently, calls for reform are nothing new. For example, in his April 2008 speech, the governor of the Bank of England told the Commons Treasury Committee, ‘I intend the Bank to contribute to the design of regulatory and incentive structures… to try to curb the excessive build-up of risk-taking and credit creation… which was seen ahead of the recent crisis.’

In July 2008, the Institute of International Finance (IIF), a global association of financial institutions chaired by Josef Ackermann, Chief Executive of Deutsche Bank, published a report on market best-practices in which compensation policies were seen as one among many factors requiring closer scrutiny and reform. ‘Market changes that have both catalysed and resulted from the growth of the originate-to-distribute business model have created incentives for both firms and individual employees that have, in some cases, conflicted with sound underwriting practices, realisation of risk management goals, or the long-term interests of shareholders’.1

Then in September 2008, talk of a massive US$700 billion bailout for the US financial services industry ushered in still more calls for compensation reform.

Legislators in the US said that incentive models in financial services are too skewed towards short-term reward. Others added that incentive systems are too asymmetrical, providing tremendous upside potential but failing to materially limit or even reduce compensation in the event of poor performance.

In general, all said that executive compensation is just too high. Not surprisingly, as part of the US bailout, legislation was drafted that would materially tie the hands of financial institutions in terms of executive compensation. For example, at those

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1 Institute of International Finance (IIF) Report – 07.08.
institutions where the federal government takes on equity, there would be limits on incentives, especially those that encourage excessive risk taking (as defined by the US Treasury Department). Similarly, the US government would expect to be able to recoup bonus or incentive payments based on earnings data that might later prove to be materially inaccurate. Finally, executives such as the attorney general in the State of New York are calling upon the most senior of financial services executives to voluntarily forego their bonuses. Whether as an act of selfless leadership or of contrition, many are complying.

The principal responses

In short, if the industry does not act on its own, it is becoming more likely that others will take matters into their own hands. So in addition to growing regulatory mandates, many elements of the financial services industry are responding of their own accord. Some of the most visible actions include:

- **A shift towards longer term incentives.**
  There is a widely held perception that the short-termism inherent in incentive plans contributed substantially to the current credit crisis. In particular, there is concern that risk and compensation are not always closely aligned. For example, an executive might be able to take a bonus based on a mark-to-market profit in one year which becomes a loss in subsequent years.

  The fundamental realisation is that bonuses should be driven not by an annual measure of performance but rather on performance measured over a period that is closer to, if not beyond, the life of the activity in question. Incentives should not require or encourage executives to execute a quick ‘flip’ when the potential for the most value creation is over the longer term.

  So executives are taking steps to replace short-incentive payouts with long-term programs featuring higher degrees of equity or deferral. Many firms are also considering making the eventual receipt of deferred bonuses subject to longer term performance: so-called clawback. This is in fact a core feature of the sweeping remuneration reforms just announced by UBS, a major recipient of bailout funds from the Swiss government.

- **A more intensive focus on risk.**
  If nothing else, the credit crisis highlights both real and potential shortcomings in the alignment between risk management and compensation. But while firms realise it is important to try to align risks more closely with compensation, the implementation is rarely straightforward.

For example, one means of introducing more risk focus into compensation is through capital charges. But invariably, disagreements over the relative riskiness of any activity ensue. Although increasingly, firms can look to third-party assessments of risk such as the capital adequacy guidelines with in Basel II, executives can disagree on the basis of special circumstances or additional steps for risk mitigation.

Ultimately, a firm communicates its risk tolerances to employees through capital allocations and bonus programs. Rewards most certainly need to guard against excessive risk taking. But equally, compensation systems need a means of discouraging the taking of insufficient risks. Striking the correct balance may be difficult, and no system is likely to be perfect, but it is essential that firms begin to do a better job of linking risk to performance.

- **A shift from individual to organisational.**
  Some companies are also attempting to shift their cultures towards a more group-wide performance orientation. In particular, senior executives need a more group-based compensation plan in order to spur broader collaboration between business units.
Introducing a broader percentage of pay based on group performance may seem simple enough. But in practice, there is likely to be considerable resistance. For example, executives whose actions and commitment are delivering strong returns will likely resent seeing their compensation diminished by loss-producing business units.

So again, as important as the concept may be, implementation remains challenging. As ever, it is a question of striking the right balance. While a degree of group performance in remuneration seems sensible, institutions should be careful to prevent too great a shift. The profits of many institutions are derived not just from teams, but also primarily from the vision and efforts of talented and motivated individuals. To go too far in the direction of group performance over individual rewards could potentially do more harm than good by removing the incentives that drive the top performers in the industry.

- **Striking a better balance between variable and fixed.**

If firms are paying too high a proportion of total compensation in the form of bonuses, then executives may need a portion of their bonuses to maintain their basic standard of living. That practice can drive executives to take on too much risk or to make short-term-oriented decisions designed to deliver bonus, not long-term value.

More than one major investment bank has allowed its compensation costs as a percentage of net revenues to rise above the normal range in order to retain key staff. If part of the bonus pool really is fixed, perhaps this should be acknowledged explicitly in how pay is structured. In essence, financial institutions are recognising that the failure to accept a higher degree of fixed costs actually contributes to risk.

- **Introducing greater communication in remuneration issues.**

Financial institutions recognise that there are fences that need mending in terms of communication with employees as well as shareholders. Firms need to engage with employees to explain the issues and develop solutions. Collaboration will lead to cooperation; action without the consultation of those expected to obey it will lead to talent flight. At the same time, executives need to communicate with shareholders regarding the changes to come as well as the associated challenges. The ultimate goal is to create compensation systems that are fair to employees while still aligning with stakeholder needs and longer term outcomes.

**Overcoming the barriers**

Firms want to reform remuneration. But in addition to the complexities noted above, there is yet another critical barrier: the difficulty of going it alone.

Consider the following scenario. Imagine if one investment bank were immediately to halve or even suspend its annual bonuses, converting instead to long-term equity incentive structures. If no other firms were taking similar actions, the immediate effect would be that top performers would leave the firm for more familiar compensation schemes. This underlines an important point about reform in compensation systems – without industry-wide support for change, it will be very difficult for individual institutions to implement significant reforms. The fear that they will lose key staff is simply too great.

One way such risks might be mitigated is through coordinated, industry-wide effort. But even in this ideal scenario, a number of firms would resist reforms, creating short-term disruption and slowing overall progress. Still, over the long term, this would be the most effective approach.
Other risks also bear mentioning. Poorly implemented reforms to a remuneration system could reduce motivation or simply fail to provide adequate incentives. The danger here is that banks restructure their compensation systems simply to please shareholders or regulators, only to find that employees are no longer sufficiently incentivised to perform to the level that is required.

But in the end, the real risk is adopting an absolute ‘wait and see’ approach. Compensation programs are currently clearly out of alignment both with risk and with the goals of shareholders. Though there may be a degree of first-mover ‘disadvantage’ in terms of talent retention, it is essential that firms begin a triage designed to solve at least their most glaring misalignments. Progress by increments is better than no progress at all.
Valuation control in turbulent times: Challenges to the operating model

by Fleur Meijs, Douglas Summa and Arjan Udding
The current market conditions have shone a bright light on financial instrument valuations and raised some critical questions for executive management.

- Do they feel comfortable signing off on the overall valuation in the financial statements?
- Do they get the right information around complex valuations?
- Do they understand the significant judgemental assumptions and the valuation complexities involved?

In this article we discuss the key areas for financial institutions to focus on as part of their review of the appropriateness and effectiveness of their valuation control processes.

**Introduction**

The credit crisis and its impact on the wider economy have introduced significant volatility and uncertainty in the financial markets. Under these circumstances it has been apparent that the valuation control processes at certain financial institutions are facing substantial challenges, as has been illustrated by some high-profile public admissions about mismarking of trading positions in the past year. With the continuing illiquidity in certain markets, this phenomenon is likely to continue and will create significant challenges for the reporting season in respect of attributing the appropriate valuations to illiquid financial instruments in the financial statements.

In this article, we will focus on the key challenges around valuation governance and control as a consequence of the recent market developments and the more important considerations in responding to them. Our observations are mainly focused on investment banks. However, we have seen similar principles being introduced and applied at other financial institutions, such as investment management and insurance companies, in order to enhance their valuation governance and control processes in response to the current market conditions.

Specifically, we believe that organisations need to review their operating model in respect of valuation control functions to ensure that they are able to effectively respond to the current challenges. Particularly, oversight by and transparency to senior management around the complexities and judgements taken in respect of valuations.

**In the eye of the storm**

Valuation control functions are regarded as a key element of the governance structure of financial institutions, with independent verification of asset prices among their core responsibilities.¹ The current markets and lack of trading information have made this independent assessment challenging. In addition, the regulators and investors are putting more pressure on the banks to better control and provide further analysis in respect of the appropriateness of their valuations.² This is explored in further detail in figure 1 overleaf.

**Building blocks of valuation control**

We have seen organisations go back to the building blocks for valuation control functions as shown in figure 2 on page 27, to analyse and improve the effectiveness of their core activities and to rebuild the confidence of the main stakeholders. This includes a review of the alignment of their operating model to current market conditions and a changing regulatory environment.

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¹ Independent price verification is the process of determining the fair values incorporated into financial statements independent of the risk-taking functions (e.g. front office).
² See for example the FSA’s ‘Dear CEO’ letter of 13 August 2008, and the SEC’s ‘Dear CFO’ letter of March 2008 on management’s discussion and analysis disclosure regarding the application of SFAS 157 (Fair Value Measurements).
Valuation control in turbulent times: Challenges to the operating model continued

Regulatory pressure
- The UK FSA’s ‘Dear CEO’ letter addresses the plan to undertake a series of visits to evaluate progress in applying prudent valuation principles, including:
  - Review of the high-level approaches that firms have adopted in relation to the valuation principles; and
  - Detailed review of the systems and processes that have been established.
- The SEC has adopted a similar view and called for more disclosure and transparency in respect of judgemental valuations in its ‘Dear CFO’ letter.

Accounting standards
- From a number of stakeholders including politicians, there is pressure to change the standards, specifically in relation to:
  - Measurement of ‘fair value in illiquid markets’; and
  - Disclosures in respect of illiquid instruments and off-balance sheet instruments.

Investor scrutiny
- Significant amount of shareholder value evaporated as a consequence of the write downs.
- Uncertainty of potential additional write downs.
- Significant pressure to produce relevant and reliable information and provide additional disclosures to provide more colour around complex valuations and significant judgements.

Limited trading volumes
- Several markets where trading activities has dried up.
- Increasing difficulty to validate the Front Office marks with very few market prices available.

Balance quality improvement with cost reduction
- Amount of time spent on data and system reconciliations rather than understanding profit and loss (P&L) and investigating valuation issues:
  - Staff and skills shortages, in particular in the more technical areas; and
  - Inefficient processes.
- Senior management ask for review of the robustness of control mechanisms.
- On the other hand, the drop in profitability has triggered a new wave of cost reduction initiatives within banks on a large scale.

Infrastructure constraints
- The infrastructure has not caught up in all cases with the growth in the Front Office and the complexity of the products.
- Certain products which were price-verified as ‘securities’ now need to be valued with models due to lack of market data.
- Flexible management information is needed to allow for a better and more timely assessment of the risks in portfolios when conditions change rapidly.

Lack of pricing data and holistic overview
- Data to validate the prices of assets are increasing hard to collect, which stresses the need for appropriate data mining.
- Furthermore, need to provide a holistic view to senior management combining information from valuation, risk management, accounting and operations.

Figure 1: Summary of external and internal pressures

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<th>External forces</th>
<th>Internal drivers</th>
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<td><strong>Regulatory pressure</strong></td>
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Source: PricewaterhouseCoopers
In our experience, the strategy and set up of the wider organisation (‘organisational drivers’) need to be considered to devise the appropriate operating model for the valuation control function. For example, an investment management organisation with less complex products typically has a leaner infrastructure and may have outsourced some or all valuation control processes to third party service providers and administrators. Hence, the role of the valuation control function and the skills and competencies required would be very different from an investment bank that is driven by innovation and has numerous complex products and instruments to price and value. Therefore, there are different models for valuation control functions applied by organisations that can work effectively when properly adapted to the wider organisational framework.

The key aspects of the operating framework need to be reviewed (i.e. the governance model, the infrastructure, human capital strategy and the actual processes and controls) in light of the current market turbulence and an assessment needs to be made of how these challenges impact the current operating model of the valuation control function. We shall consider each of these aspects in more detail.

**Governance and organisational structure**

- Is there sufficient oversight by senior management to assess the significant and highly judgemental valuation matters?

- Is there a clear valuation control strategy with a supporting target operating model?

- Are globally consistent policies in place to address the core activities and have they been updated for recent market circumstances?

- Are the roles and responsibilities of the function, including handover points with other departments, clearly documented and understood?

- What are the characteristics of the culture and does the operating model promote the desired cultural behaviours?

- Have outsourcing/off-shoring arrangements performed satisfactorily during recent market conditions?

**Governance**

Irrespective of how the function is set up, the oversight by and reporting to senior management is a critical component of valuation control. Controls and processes can be split between several different units within the same function or sometimes between several different functions across different regions, which makes it difficult to obtain a comprehensive overview and to gain appropriate insight into issues identified. The key is to distil the critical processes and controls to ensure senior management obtains correct, relevant and timely information to allow them to make appropriate decisions in respect of judgemental valuations. In addition, they also need to obtain summarised information around the quality of their processes and the complexity of their valuations.

The overall culture of the organisation and that within a valuation control function has been a key factor in driving a successful control environment. We have seen that within banks with an effective risk management structure, front office, back office and controlling functions have an equal say and can challenge each other appropriately. In such an environment different views on overall valuations are properly discussed and reconciled to ensure a robust view is reached on complex valuations. Based on our experience with leading firms who have strong cultures, we have identified the following key cultural attributes, which we believe contribute to an overall robust control environment:
The desired culture is defined and integrated throughout the organisation:
Leaders act as clear role models for other team members and personal objectives aligned with desired organisational culture and linked to rewards;

- Full transparency – rapid escalation of issues, quick to admit mistakes;
- Attention to detail – applies to all levels and all departments;
- Continuous improvement – emphasis on lessons learned from unexpected events (positive or negative);
- ‘Collegial tension’ – challenging others is the expected behaviour of ‘real partners’;
- Leaders of support and control functions have equal stature to front office personnel – no overrides; and
- Detailed policies and procedures, especially in the area of complex structured products, are supplemented by good judgment.

Organisational structure
There are a wide range of models for a valuation control function. In figure 2, we have included some of the key components of valuation control. In many investment banks the model control function is part of a risk management function, whilst the other components typically fall in the responsibility of Product Control. However, as stated before, the specific set up of the function should be aligned to the organisation’s business model, product mix and the firm’s infrastructure.

Reliance on and interaction with other departments is important and in particular, finance and risk interaction has been identified as one critical factor in identifying and mitigating credit crunch losses. A relevant publication, ‘Senior Supervisors Group – Observations on Risk management practices during the recent market turbulence’\(^3\) performed a comparison of the practices at organisations that have not suffered significant write-offs versus those organisations that have had large losses. Some ‘best’ practice areas included were as follows:

- Senior oversight – Effective firm-wide risk identification and analysis, and better sharing of key risk management reports, both quantitative and qualitative. Senior management was involved in decision making.
- Comprehensive risk-monitoring capabilities – Informative and responsive risk measurement and management reporting and practices. Use of different methods to look at risk to gather more information and different perspectives on the same exposures.
- Robust valuations – Consistent application of independent and rigorous valuation practices across the firm.

Organisations that have focused on creating an effective relationship between risk and finance, ensure there is frequent and effective interaction between key stakeholders on a day-to-day basis and appropriate governance through formal bodies such as the valuation committee, reserving committee, risk committee, business planning committee, etc.

They have a clear definition of roles and responsibilities of all stakeholders, including detailed sign off and escalation procedures, and ensure appropriate hand-offs between stakeholders, e.g. in respect of the model control being performed by risk and the independent price verification by a product control function.

Additionally, they are able to combine risk and financial results reporting to ensure a more holistic view is provided in relation to business performance and the associated risks.

\(^3\) Senior Supervisors Group, ‘Observations on Risk Management Practices during the Recent Market Turbulence’ – 06.03.08.
Figure 2 – Drivers and key aspects of a valuation control operating model

- Complexity and breadth of product range
- Pace of innovation
- Governance and organisation
- Independent price verification
- P&L reporting
- Reserving
- Infrastructure
- Human Capital
- Complexity of infrastructure
- Geographical diversity
- Organisational drivers
- Key aspects of the operating model/framework
- Core activities

Source: PricewaterhouseCoopers
Valuation control in turbulent times: Challenges to the operating model continued

Processes and controls

- Do you obtain independent valuations for all your positions? Are they reliant on internally developed models? Do you have management information that presents you with the quality of the valuation control processes?

- Does your daily P&L reporting process adequately explain the drivers of the P&L, particularly for more complex areas of the business?

- Does management reporting highlight the areas with issues where decisions need to be made by senior management?

- How is that information shared, i.e. are other departments made aware of significant valuation issues/control breakdowns?

- How do you ensure that your processes and controls comply with changes in regulation and accounting?

Independent verification of the Front Office valuations has become much more difficult due to the current market conditions. There has been an increasing reliance on model based valuations and management judgement in the past year and this makes the transparency and control around those processes an important component of effective valuation control. Specifically, model review and calibration to market data, where available, has been a focus of many organisations to ensure they can place reliance on model based valuations in the absence of quoted prices.

As noted above, it is important to report on the effectiveness of the control processes to senior management, e.g. the level of positions actually independently verified to external data and the quality of that data. Besides reporting to senior management, there also needs to be a forum for escalation and decision making at a senior level to appropriately evaluate complex and significantly judgemental valuations.

Human capital

- Does your valuation control function have sufficient product knowledge and quantitative expertise to challenge the business on valuation issues?

- Do you have enough senior resources to be able to challenge the front office appropriately, especially in areas where more judgement is required?

- Does your valuation control function have acceptable staff turnover levels?

The significant changes in the financial markets have increased the need for senior management to reassess whether they still have the right number of people with the right skills in the appropriate areas. The valuations have become more complex and as such a different skill set and level of experience may be needed to cope with the current issues. In recent years there has been a move in a number of organisations to create more quantitative skills within valuation control functions to be better equip them to deal with valuations of complex products in illiquid markets.

Current hiring freezes and redundancies are likely to compound the current challenges, the volume of work for valuation control functions is increasing as opposed to decreasing. High staff turnover and a significant proportion of temporary staff can also add significant problems. We have observed instances where this has led to significant issues due to inappropriate training, handovers and for poor understanding of processes and controls to be performed leading to a breakdown in control.
Infrastructure

- Is there a common data source for valuation processes?
- To what extent are processes automated and how is the use of spreadsheets controlled?
- Is the data used for the valuation process reliable?

Support functions can easily be behind in respect of infrastructure developments compared to the front office. For example, systems and processes are often unable to sufficiently deal with complex structured products, leading to the following issues:

- Complex system infrastructure and default use of spreadsheets;
- Largely manual processes and high workload;
- Lack of common data sources;
- Out of date or incomplete inventories and mapping of products and models; and
- Problems around handover points (information flow between stakeholders).

49% of financial services companies have already cut back on their IT spend in response to the global economic slowdown.⁴ We believe, however, that these short-term cost reductions can prevent organisations from making necessary strategic investments to improve the infrastructure. Looking at the symptoms above, productivity, efficiency and control gains are to be found. Senior management should consider the possibility that targeted strategic investments might generate savings (and revenues) exceeding that which could be saved through short-term cost cutting.

Conclusion

In these difficult times it is important for senior management to review the appropriateness of the valuation governance and control operating model to ensure that they are able to respond appropriately to the current challenges. As part of this we recommend focusing on the following key areas:

- Establishing governance and oversight over the determination of judgemental valuations and accounting application, especially quality control and transparent reporting to senior management on key judgements and valuation decisions;
- Creating a robust process around independent verification of valuations and assessment of the appropriateness and calibration of models to available market information;
- Ensuring the right culture is in place in organisations to allow for adequate challenge and ‘bad messages’ to support an equal balance between front offices and support functions;
- Investing in skills and technology to enhance the control framework around valuations and complex accounting issues; and
- Increasing interaction with other parts of the organisation, to ensure that a comprehensive, holistic and integrated view of risk, valuation and accounting issues is formed.

⁴ ‘Slowdown sees groups cut IT spending’, Financial Times – 09.09.08.
Basel II Pillar 3: Challenges for banks
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).

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
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 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
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.
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