Disclosure as a Supervisory Tool: Pillar 3 of Basel II

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Please note that the views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of San Francisco or of the Federal Reserve System.

Overview

International efforts to improve the regulation and supervision of banking institutions are well under way.

In April 2003, the Basel Committee on Banking Supervision released the new Basel Capital Accord, which will replace the 1988 Accord.

On July 11, the Federal Reserve issued an advance notice of proposed rulemaking on the implementation of the Accord in the U.S.

Overview (continued)

The new Accord, popularly known as Basel II, rests on three "pillars":

Pillar 1: making regulatory capital requirements more risk sensitive

Pillar 2: refinements of current supervisory processes regarding capital adequacy issues

Pillar 3: enhanced public disclosure requirements focusing on capital adequacy

Overview (continued)

Banking institutions are monitored by customers, trade counterparties, and investors.

This type of monitoring is generally known as “market discipline”.

The principle underlying Pillar 3 is that improved public disclosure should enhance market discipline and hence its potential usefulness to bank supervisors.

Overview (continued)

This talk reviews recent policy developments regarding disclosure by banking institutions, focusing on the disclosure requirements in the proposed Basel Accord.

- Market discipline & current public disclosure
- Details of Pillar 3
- Implementation issues

Background on Basel I

Implemented in 1988; established 8% minimum capital ratio for internationally active banks

Current U.S. capital standards based on Basel I

The required capital covers all risks,
but the rules only address credit risks.

"Broad brush" and lacks risk differentiation

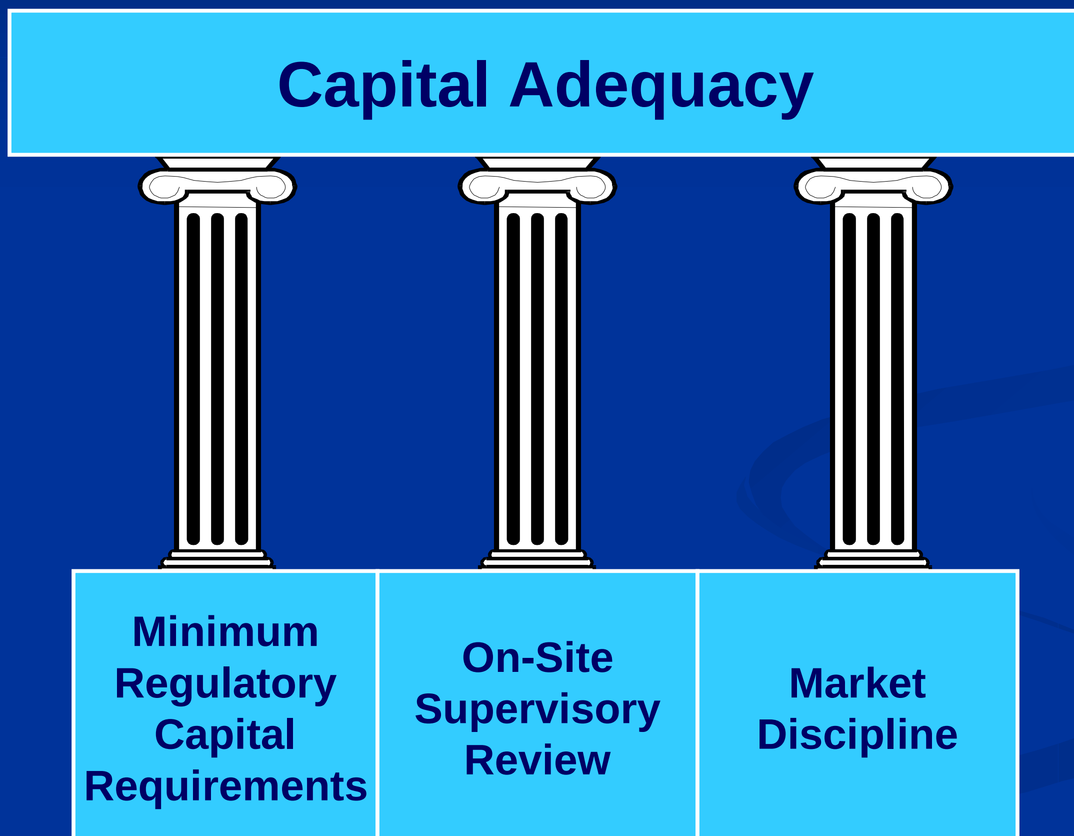
Background on Basel II

Multiple goals:

- respond to regulatory arbitrage observed more frequently in the mid-1990s
- encourage improvement of risk management, esp. credit risk and operational risk
- create a regulatory capital framework more closely aligned with underlying bank risks

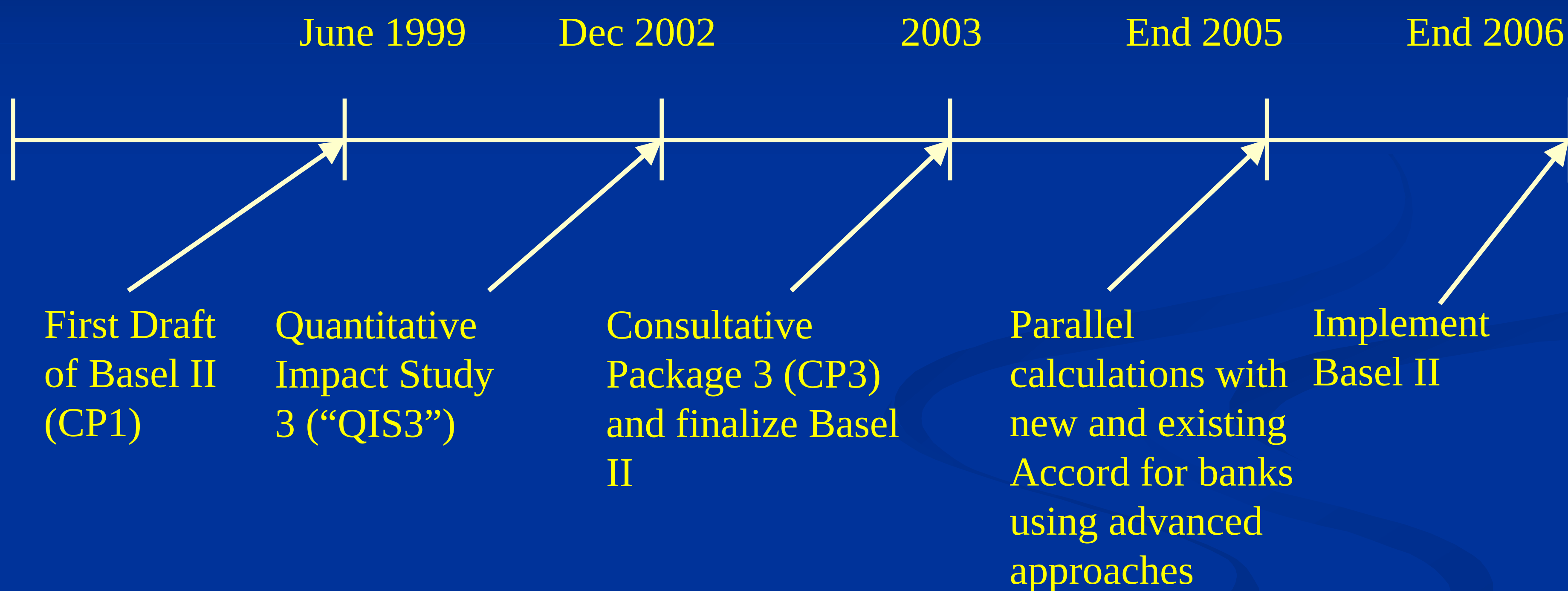
End result: banks will be subject to three mutually reinforcing pillars of sup. & reg.

Background on Basel II



Graphic provided by Walter Yao

Background on Basel II



Graphic provided by Walter Yao

Market Discipline

Direct market discipline refers to the control or influence market participants have over a bank's behavior.

- expressed directly via funding costs

Indirect market discipline arises from pricing information in the primary and secondary markets for bank securities.

- demand for higher return if more risk
- signal to counterparties and supervisors

Market Discipline (continued)

With the growing complexity of banking organizations, policymakers have advocated leveraging market forces to enhance the safety and soundness of the banking system.

Research into BHC debt and equity securities indicate that their market prices accurately reflect BHC conditions and would be a useful source of information for banking supervision.

(see Krainer & Lopez (2003) for further details)

Market Discipline (continued)

2003 Basel Committee study on the bank equity and debt market:

- issuance of subordinated debt is currently not sufficient for direct market discipline
- however, indirect market discipline would be possible for a group of large intl. banks

- equity markets could be used for indirect market discipline, but not direct

Current disclosure standards

For market discipline to be effective, banks must be sufficiently transparent; i.e. provide sufficient, accurate and timely information regarding their conditions and operations.

As discussed in a Fed staff study from 2000, U.S. bank disclosure standards are a byproduct of the demands of market participants and regulatory agencies as well as of the choices made by bank management.

Current disclosure standards (con't.)

In the U.S., core disclosure requirements for publicly-traded banks are set by the SEC as well as FASB

- the audited annual Form 10-K

- the unaudited quarterly Form 10-Q

- Form 8-K made in connection with special circumstances, such as the intention to issue new debt or equity securities

Current disclosure standards (con't.)

Important caveat:

Although this overall regulatory reporting structure leads to a great deal of public disclosure, banks have a large degree of flexibility in meeting SEC disclosure requirements and thus maintain some control over what information is disclosed.

Current disclosure standards (con't.)

An example is the Fed study's analysis regarding SEC required disclosure of market risk exposures; based on value-at-risk estimates.

Bank VaR disclosures vary in detail across banks and have an unclear connection to actual trading performance during 1998.Q3.

However, Jorion (2003) found that such VaR numbers do predict trading revenue volatility.

Current disclosure standards (con't.)

In addition, all banks, whether publicly or privately owned, must file quarterly regulatory reports, such as the bank-level Call Reports.

- Schedule RI: income statement
- Schedule RC: balance sheet
- Schedule RC-L: derivatives & OBS items
- Schedule RC-N: past due & nonaccruals
- Schedule RC-R: regulatory capital

Accessible at FRB Chicago's website

http://www.chicagofed.org/economicresearchanddata/data/bhcdatabase/index.cfm

Current disclosure standards (con't.)

Also, formal enforcement actions and cease-and-desist orders are public documents

http://www.federalreserve.gov/boarddocs/press/enforcement/2003/default.htm

For example, the agreement with Citigroup and Morgan regarding the aftermath of their Enron dealings

For example, the agreement with HSBC USA to strengthen its anti-money laundering measures

Current disclosure standards (con't.)

Overall, bank disclosure appears to be improving over time.

A recent survey of internationally active banks by the Basel Committee found that they have expanded the nature of their disclosures.

In the U.S., the private sector Working Group on Public Disclosure proposed further disclosure of market and credit risk information.

Pillar 3 details

In an effort to continue this trend and to improve the ability of bank supervisors to use market discipline for their own monitoring purposes, the Basel Committee has made disclosure a key component of the new Capital Accord.

Qualitative & quantitative disclosures regarding:

- corporate structure
- capital structure & adequacy
- risk management

Pillar 3 details (continued)

Corporate structure: how is a banking group organized; ex., how are subs. consolidated for accounting and regulatory purposes

Capital structure: how much capital is held and in what forms, such as common stock

Risk management: the focus is on bank exposures to credit risk, market risk, risk from equity positions, and operational risk

Credit risk disclosure

Credit risk is defined as the potential losses arising from borrowers not repaying their debts.

Qualitative discussion of bank policies:

- key definitions
- statistical methods used
- information on supervisory acceptance of their approach

Credit risk disclosure (continued)

Quantitative disclosures:

- total gross credit risk exposures after accounting for offsets and without taking account of credit risk mitigation efforts
- exposures disaggregated by:

  type (ex., loans, OBS exposures)

  geographic region

  industry

  residual contractual maturity

Credit risk disclosure (continued)

Quantitative disclosures:

- impaired loans and past-due loans by geographic region and industry type
- a description of internal ratings systems & amount of exposure in each rating category
- key credit risk model parameters, such as default probabilities, credit exposures in case of default, and losses given default
- historical credit risk losses

Market risk disclosure

Qualitative disclosures:

- management policies
- statistical methods used in their models
- model validation & stress-testing procedures

Quantitative disclosures:

- capital requirements by category
  (interest rate, equity, FX & commodity)
- value-at-risk measures
- comparison w/ actual outcomes (backtesting)

Equity risk disclosure

For risk from equity positions, banks must disclose the types, amounts and nature of investments in public and private firms, as well as their total gains or losses, whether realized or not.

Operational risk disclosure

Operational risk is the risk of losses resulting from inadequate or failed internal processes, people, & systems, or from external events.

Aside from a qualitative discussion of their approach to managing such risks and supervisory approval, banks using advanced approaches must describe their modeling approaches as well as risk charges before and after any reductions resulting from the use of insurance.

Implementation issues

These proposed disclosure requirements are far-reaching and are intended to improve market discipline and its usefulness to supervisors.

Yet, how well the requirements might work in practice depends on how they are implemented.

- accuracy
- frequency
- proprietary nature
- materiality

Implementation issues (continued)

<u>Accuracy:</u>

Although disclosures must not be overly burdensome on reporting banks, they must be accurate.

Pillar 3 disclosures needn’t be audited externally, unless required by other authorities, but management should ensure that the information is appropriately verified.

Implementation issues (continued)

Frequency of disclosures:

Annual qualitative summaries of risk management policies should be sufficient

Many variables, such as regulatory capital ratios, are to be reported quarterly

More frequent disclosures have not been proposed and could be overly burdensome, but may become commonplace in the future.

Implementation issues (continued)

<u>Proprietary nature:</u>

An important implementation issue is determining whether information is proprietary and hence should not be disclosed.

Specific items that may prejudice a bank's proprietary information needn't be disclosed, but more general information about the subject matter must be, together with an explanation of why those specific items were not disclosed.

Implementation issues (continued)

Materiality:

Determining whether specific disclosure items are material is another challenge.

Banks should decide if disclosures are material based on commonly accepted principles;

i.e., information is material if its omission might change or influence the assessment or decision of a user relying on that information.

Conclusion

In conclusion, many implementation details are addressed within the Pillar 3 disclosure requirements, but many specific questions and additional issues will arise.

It is reasonable to assume that as these issues are worked out, the improved disclosure by banks should facilitate market discipline, contribute to supervisory monitoring efforts, and enhance the stability of the national and international banking systems.

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