

Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

7 October 2014

Dear Sirs,

**Review of the Pillar 3 disclosure requirements - consultative document**

Autonomous Research welcomes the opportunity to respond to the Committee's Review of the Pillar 3 disclosure requirements. Autonomous Research is an independent research firm which is focused on the financial services sector. We publish in depth research on financial companies in Europe and the US, and will launch coverage of Asian banks next year. Our client base is entirely institutional, and often invests on a global basis.

Given the global mandate of our research and our client base, we wholeheartedly support the Committee's desire to 'improve comparability and consistency' of disclosure. Our analysis is often hindered by the inability to make adequate comparisons between banks, and frequently by the lack of consistent historical data for individual institutions. We therefore support the Committee's proposals to provide a greater degree of standardisation, including an increased use of templates to achieve this.

We also support the Committee in its goal to introduce greater prescription on the timing and frequency of disclosures. While the majority of the largest global banks provide financial reports on a quarterly basis, this is not always the case, and, moreover, the quality of the quarterly disclosure is hugely varied.

We agree with the Committee's view that more rigorous disclosure is required to address market concerns about the efficacy of model based RWAs. There is clearly a crisis of confidence amongst investors and analysts in the comparability of banks' RWAs. This has given rise to an increased focus on measures of leverage, and some calls for all RWAs to be calculated on a standardised basis. We think providing much better disclosure on how banks arrive at their risk weightings will help address this lack of confidence. While the banks may resist the burden of providing such an increase in disclosure, we think it is a price they will have to pay if they wish to retain the advantages of model based RWAs.

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We are therefore in agreement with the approach the Committee has taken in its Review, and support the majority of the recommendations it makes. However, we are mindful of the Committee's comments that 'Disclosures should be meaningful to users'. We fear that disclosure of data which are not relevant for users can diminish or obscure the information which is of genuine use when understanding the risks a bank has undertaken, and the RWAs which those risks produce. We believe that in some of its scope, the Review errs on the side of over disclosure, and we highlight a number of proposals which we think can either be removed, or produced less frequently.

We would also like to highlight a number of areas which the Phase 1 Review does not address, but which we feel are of urgent interest to bank analysts and investors:

- **IFRS9**: The forthcoming replacement of IAS 39 with IFRS 9 will create significant new disclosure requirements for the banks in their financial reporting with regards to impaired assets. There is currently little focus on IFRS 9 from the investor and analyst community, with far more attention instead on the ECB's Comprehensive Assessment. However, we believe that interest in IFRS 9 will start to increase in 2015, and certainly by the time of the Committee's recommended implementation of the new Pillar 3 disclosures (mid 2016). We are concerned that many of the concepts which the IFRS 9 impairment approach introduces are analogous to the regulatory capital disclosures (eg expected loss). We are also concerned that a number of new and differing definitions of defaulted assets will be disclosed simultaneously. We would therefore urge the Committee and the IASB to work together in order to a) make any amendments to the Pillar 3 templates which could facilitate an understanding of the bridge between regulatory and accounting concepts of default and expected loss under IFRS 9; b) ensure that investor education is a high priority so as to avoid confusion when a large volume of new disclosure is produced.
- **Operational risk**: In recent years, investors have become increasingly concerned about operational risks, which have led to significant charges for the banks. This includes the cost of customer remediation and fines/litigation charges related to past misconduct. For a number of banks, this has led to an increase in the level of Operational RWAs. There is currently almost no disclosure as to how these RWAs are calculated, or why they change from period to period, and the Phase 1 Review does not propose to address this. We note that the Committee intends to provide more information in its Phase 2, but we feel increased disclosure should be accelerated to Phase 1, even if it requires some further fine tuning in Phase 2.



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- **Pillar 2:** We note that the Review makes no reference to Pillar 2 capital requirements, which are also excluded from the Committee's *Composition of capital disclosure requirements*. A number of jurisdictions are including elements of Pillar 2 (eg pension risk) as part of the required minimum capital for the banks. While some of this will be addressed in the proposed Phase 2 work of the Committee (eg interest rate risk in the banking book), we are concerned that there is no comprehensive format for disclosing this information. We understand that there is a significant divergence of views on the disclosure of Pillar 2, but we feel it is critical that the Committee provide guidance if investors are to be able to understand banks' capital requirements on a consistent basis.

Our more detailed response to the Committee's Review can be found in two annexes:

- **Annex 1** lists a number of items which we believe are relevant in all of the templates. It also addresses the issue of timeliness and frequency of reporting.
- **Annex 2** provides comments on the individual templates, noting which are of particular importance, and querying aspects of their design.

Yours faithfully,

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## **Annex 1 - General remarks on the proposals**

### **Frequency**

We are strong believers in the benefits of banks producing detailed quarterly financial information, and we support the Committee's desire to provide some Pillar 3 data on a quarterly basis. However, we have some concerns on:

- The volume of data which the Review proposes to be provided quarterly, some of which is unlikely to show a material change between quarters.
- The Review's proposal that a number of templates should be provided 'As frequently as financial reporting'. We fear that this definition is too vague, and leaves open a question as to what should be considered 'financial reporting'. At what point, for example, does an 'interim management statement' become 'financial reporting'? Our fear is that some banks may use the new Pillar 3 disclosure requirement as an excuse to pare back quarterly financial reporting so that they do not have to provide increased Pillar 3 disclosures simultaneously.

We therefore:

- propose that the Committee introduce three clear categories for disclosure, 'Quarterly', 'Half yearly' and 'Annually';
- indicate in Annex 2 the frequency with which we think these disclosures should be required.

### **Timelines**

The Committee proposes that Pillar 3 should be published 'concurrently' with financial reporting. However, we note that many banks produce different sets of financial reports, both preliminary and final. In many cases, the final reports may only be released some time after the preliminaries, particularly for year end disclosures (for example, Annual Reports are often produced a couple of months after the initial release of financial figures). This delay can often mean that by the time the full financial reports have been published, management has already undertaken the large majority of investor and analyst meetings, and so management is not questioned on information released in these final numbers. We think the Committee needs to clarify its intentions with regards to the expected publication of Pillar 3, and, ideally, encourage it to be produced at the same time as preliminary results.

### **Definition of default**

In a number of templates (CR1, CR2, CRB), the Review introduces the concept of 'defaulted assets'. As mentioned in our introductory remarks, we are concerned that this definition of default will differ from other definitions which banks may produce elsewhere eg for IAS 39 / IFRS 9 purposes. We would therefore propose:

- table CRB contain a clear definition of default for regulatory purposes; and
- the Committee work with the IASB to provide a bridging table to help understanding of the definition of default in the regulatory reports and the financial statements.

### 'Capital Requirements'

In many of the templates, there is a requirement to produce a 'capital requirement' figure. In certain templates (eg MR1 and MR2), the capital requirement is provided but the RWAs are not given, an inconsistency in presentation which is unhelpful.

Given that this is a simplistically derived number (our understanding is that it is simply 8% of RWAs), and that it does not reflect the banks' actual capital requirements (it ignores Pillar 2 and other buffers), we propose removing this entirely from the Pillar 3 document.

### Credit Risk Mitigation

A number of the templates (CR3/4/5/6) aim to capture the nature of credit risk protection which is used to mitigate risk. While we are in favour of increased disclosure in this area, we are concerned that:

- the templates require the banks to classify the reduction in exposure due to the value of collateral held. However, in our experience, investor concern is more focused on the approach the bank takes to valuing the collateral, rather than the simple existence of that collateral. The numbers provided in CR3 and CR4 rely on banks' own collateral valuation of these metrics, which reduces the value of the disclosure in our view;
- where the Review tries to assess the reliability of guarantees (CR5) or derivative counterparties (CR6), it uses external ratings as a benchmark. We do not believe investors would regard this as an adequate measure of reliability, which diminishes the usefulness of these templates.

In general, we think the mitigation disclosures should be reconsidered. To increase their usability, we think disclosure should include an overview of the exposure by class (e.g. residential real estate, commercial real estate, other asset based finance, other); the amount of exposure that is collateralised; the initial value of the collateral; the current value of the collateral; and the type of collateral (personal guarantee, financial guarantee, mortgage, etc) so that different loan to value statistics can be ascertained. Ideally, there should also be a differentiation by geography, where applicable. Given this additional data requirement, we suggest providing this disclosure on an annual basis.

### Suggested additional summary table

We think template CR9 provides a very useful summary of the parameters driving RWA density for IRB models. However, we find that investors frequently require an overall snapshot of RWA density by portfolio, which the current Review does not provide. We therefore suggest an additional template should be produced, with a quarterly frequency, which provides this summary view (see below).

### **Summary of EAD and risk density by portfolio**

| Portfolio  | Total per B/S* | Exposure at default (EAD) |                  |          |          | RWAs  |                  |          |          | RWA density |                  |          |          |
|------------|----------------|---------------------------|------------------|----------|----------|-------|------------------|----------|----------|-------------|------------------|----------|----------|
|            |                | Total                     | o/w Standardised | o/w FIRB | o/w AIRB | Total | o/w Standardised | o/w FIRB | o/w AIRB | Total       | o/w Standardised | o/w FIRB | o/w AIRB |
| Mortgages  |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |
| Corporates |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |
| etc        |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |
| ....       |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |
| ....       |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |
| ....       |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |
| Total      |                |                           |                  |          |          |       |                  |          |          |             |                  |          |          |

Source: Autonomous. \*Net loans, as reported in financial statements

## Annex 2: Comments on specific tables and templates

| Tables and templates | Suggested frequency (shaded where different to Review) |               |          | Comments                                                                                                                                                                                                                           |
|----------------------|--------------------------------------------------------|---------------|----------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                      | Quarterly                                              | Semi annually | Annually |                                                                                                                                                                                                                                    |
| OVA                  |                                                        |               |          | We are unclear how this disclosure interacts with existing risk management descriptions in the annual reports - are they intended to be the same?                                                                                  |
| OV1                  | x                                                      |               | x        | We suggest removing columns b and c. We suggest adding a column with a measure of EAD. We are unclear why row 7 is shaded in column a                                                                                              |
| LI1                  |                                                        |               | x        | Columns c - g appear to represent a regulatory split of financial statement disclosure, but not the actual regulatory exposure. If so, this is not useful disclosure. Better to include the 'differences' element from LI2         |
| LI2                  |                                                        |               | x        | If LI1 is amended as suggested above, LI2 would be better split by financial statement category                                                                                                                                    |
| LIA                  |                                                        |               | x        | See above                                                                                                                                                                                                                          |
| CRA                  |                                                        |               | x        | No comment                                                                                                                                                                                                                         |
| CR1                  |                                                        | x             |          | Very useful table, but a) how are 'gross values' to be defined in columns a-d? (eg where do restructured assets sit) b) the definition of default is likely to contrast with that in financial statements and will cause confusion |
| CR2                  |                                                        | x             |          | As per CR1, there is likely to be confusion on definition of default                                                                                                                                                               |
| CRB                  |                                                        | x             |          | Many banks provide information of these exposures already; it should be a semi annual requirement; this may be better presented as a fixed template                                                                                |
| CRC                  |                                                        | x             |          | No comment                                                                                                                                                                                                                         |
| CR3                  |                                                        |               | x        | We question the value of this disclosure in its current form (see comments in Annex 1)                                                                                                                                             |
| CR4                  |                                                        |               | x        | We question the value of this disclosure in its current form (see comments in Annex 1)                                                                                                                                             |
| CR5                  |                                                        |               | x        | We question the value of this disclosure in its current form (see comments in Annex 1)                                                                                                                                             |
| CR6                  |                                                        |               | x        | We question the value of this disclosure in its current form (see comments in Annex 1)                                                                                                                                             |
| CRD                  |                                                        |               | x        | No comment                                                                                                                                                                                                                         |
| CR7                  | x                                                      |               |          | The definition of 'securities firm' needs clarification. Where 'capital requirements' is footnoted, it is unclear is EL surplus / shortfall is intended to be included in column g, or only in capital disclosures                 |
| CR8                  | x                                                      |               |          | Add an extra column with (weighted) average risk weight. Define "securities firm"                                                                                                                                                  |
| CRE                  |                                                        |               | x        | We are unclear if all approved models need to be included in here, or if there is a materiality threshold. The disclosure could become unwieldy if all models are explained.                                                       |
| CR9                  | x                                                      |               |          | Very useful table, bringing together key elements (PD/LGD/RWA density) in one place, and adding new detail (eg on EL). We have some concern that the low end of the PD scale may need to be more granular.                         |
| CR10                 |                                                        |               | x        | Without knowing the quality of the CRM (see comments re CR3-6) we question the value of this disclosure.                                                                                                                           |
| CR11                 | x                                                      |               |          | We would suggest a combined RWA flow statement, including CR11, CCR7, MR3                                                                                                                                                          |
| CR12                 |                                                        |               | x        | Needs clarification on whether average historical default rate is weighted average or arithmetic average                                                                                                                           |
| CRF                  |                                                        |               | x        | No comment                                                                                                                                                                                                                         |
| CR13                 | x                                                      |               |          | Remove 'capital requirements'                                                                                                                                                                                                      |
| CCRA                 |                                                        |               | x        | No comment                                                                                                                                                                                                                         |
| CCR1                 | x                                                      |               |          | Is the number (1.4) in Cell C3 a fixed value for standardised calculation of alpha?. It is also unclear why 'Total' EAD is shaded. Remove 'capital requirements'                                                                   |
| CCR2                 |                                                        | x             |          | Unclear why total portfolios RWAs/capital requirements are shaded, or the total in row 4. Remove capital requirements.                                                                                                             |
| CCR3                 | x                                                      |               |          | Add an extra column with (weighted) average risk weight. Define "securities firm"                                                                                                                                                  |
| CCR4                 | x                                                      |               |          | Unclear how 'gross exposure' will be calculated in this instance                                                                                                                                                                   |
| CCR5                 |                                                        | x             |          | Useful new disclosure. No need to split cash into domestic / other currencies. Why is SFT collateral not split into 'segregated' and 'unsegregated'?                                                                               |
| CCR6                 |                                                        | x             |          | Useful disclosure, but why it is only focused on credit derivatives? Would be useful to see for all products (rates, FX, equities etc)                                                                                             |
| CCR7                 | x                                                      |               |          | We would suggest a combined RWA flow statement, including CR11, CCR7, MR3                                                                                                                                                          |
| CCR8                 |                                                        | x             |          | Useful new disclosure. Remove column C. Unclear why 'Totals' in rows 1 and 11 are shaded.                                                                                                                                          |



| Tables and templates | Quarterly | Semi annually | Annually | Comments                                                                                                                                                                                           |
|----------------------|-----------|---------------|----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| SECA                 |           |               |          | No comment                                                                                                                                                                                         |
| SEC1                 |           | x             | x        | May be better combined with SEC3 so an overview is more easily presented                                                                                                                           |
| SEC2                 |           | x             |          | We do not believe such a detailed level of flow information is required                                                                                                                            |
| SEC3                 |           | x             |          | May be better combined with SEC1 so an overview is more easily presented                                                                                                                           |
| SEC4                 |           | x             |          | We do not believe such a detailed level of flow information is required                                                                                                                            |
| SEC5                 |           | x             |          | Underlying assets need to be clarified ('Retail underlying' captures a broad range). It is also unclear if rows 4-6 are intended to sum to row 3                                                   |
| SEC6                 |           | x             |          | Underlying assets need to be clarified ('Retail underlying' captures a broad range). It is also unclear if rows 4-6 are intended to sum to row 3                                                   |
| MRA                  |           |               |          | No comment                                                                                                                                                                                         |
| MRB                  |           |               | x        | Does (B) E (i) to (vi) require separate disclosure for each VAR model used? And for (C) and (D), how are multiple approaches to be explained?                                                      |
| MR1                  | x         |               | x        | Should be focused on giving RWAs, not capital requirements                                                                                                                                         |
| MR2                  | x         |               |          | Should be focused on giving RWAs, not capital requirements                                                                                                                                         |
| MR3                  | x         |               |          | We would suggest a combined RWA flow statement, including CR11, CCR7, MR3                                                                                                                          |
| MR4                  |           |               |          | Useful to force this disclosure on a consistent basis from the banks, but should there be a materiality test as to whether it is worthwhile information (eg exclude banks with IMA < a threshold)? |
| MR5                  |           | x             |          | As above                                                                                                                                                                                           |

Source: Autonomous