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Standard & Poor's Supports The Basel Committee's Proposals To Enhance Banks' Pillar 3 Disclosures

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*(**Editor's Note:** The following is Standard & Poor's Ratings Services' response to the Basel Committee on Banking Supervision's consultative document "Review of the Pillar 3 disclosure requirements," issued June 24, 2014. The views expressed in this response represent those of Standard & Poor's Ratings Services and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services, LLC. We intend our comments to address the analytical needs and expectations of our credit analysts. Our current ratings criteria are not affected by our comments on the consultative document.)*

Standard & Poor's believes that timely disclosure of relevant, comparable, and consistent information about a bank's capital and risk exposures in Pillar 3 reports contribute to the effective operation of market discipline over banks. In this respect, the Basel Committee on Banking Supervision's proposed revisions to Pillar 3 reporting requirements in our view represent a substantial improvement over existing requirements and would thus enhance market discipline. The consultation sets out proposals for enhanced Pillar 3 disclosures in the areas of credit, counterparty credit, securitization, equity, and market risks that would come into effect on April 1, 2016. The proposals would allow users to better reconcile a bank's prudential exposures with its financial statements and obtain timely information on key risks and exposures in standardized, highly comparable formats. We think the proposals answer a number of the shortfalls we had raised regarding current Pillar 3 disclosure requirements (see "Standard & Poor's Response To The EBA Highlights The Shortcomings Of Banks' Pillar 3 Disclosures," published on March 7, 2013, on RatingsDirect.) In particular, we believe that the proposed use of standardized templates, with clear definitions, is necessary to address the issue of comparability.

We believe the proposals could be enhanced further in some areas to more fully achieve the Basel Committee's aim of Pillar 3 reporting "to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution." In particular, we believe that the lack of granularity in the proposed requirements regarding exposures by geography and asset class, as well as discrepancies in disclosures between the standardized and the internal ratings-based (IRB) approaches, limits transparency and comparability across banks.

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Overview

- More consistent, comparable, and timely Pillar 3 disclosures would benefit capital markets by providing greater insight the key risk exposures of banks. We believe that the scope of the proposals should be extended to require key Pillar 3 disclosures by debt-issuing bank subsidiaries.
- We don't always consider quarterly Pillar 3 data to be useful. A detailed annual Pillar 3 report and a half-year Pillar 3 report with less narrative and more of a focus on quantitative disclosure would be appropriate, in our view.
- The proposed disclosures include templates to show linkages between regulatory balances in banks' Pillar 3 reports and accounting balances in their financial statements, which we believe will enhance transparency.
- The proposed credit risk disclosures would benefit from greater granularity about exposures by geography and asset class.
- The scope of regulatory requirements for credit valuation adjustments (CVAs) varies across jurisdictions, undermining the comparability of the proposed CVA disclosures for counterparty credit risk.
- Pillar 3 disclosures for securitizations and market risk are often particularly weak, and the proposed enhancements would represent a significant step forward in these areas.

We are frequent external users of Pillar 3 information provided by banks as we systematically examine the Pillar 3 disclosures when rating financial institutions, especially for our capital, earnings, risks, and funding and liquidity assessments of banks. Although Pillar 3 disclosure reports have greatly improved since their first publication in 2007, they do not yet fully achieve the goal of better market discipline, in our view. However, we believe that the proposals set out in the Basel Committee's consultative document represent another step ahead in the development of Pillar 3 reporting. Furthermore, we understand that the Basel Committee, in a second phase of its work on Pillar 3 starting next year, will look at enhancing the disclosure of other key elements that are necessary for a fuller understanding of a bank's risk profile, including, in particular, operational risk and interest rate risk in the banking book, but also the inclusion of disclosures on capital requirements and capital buffers. In our view, as further prudential rules become applicable--including, for example, rules on total loss-absorbing capital (TLAC) and recovery planning and resolution strategies--Pillar 3 reporting requirements should be developed to ensure that disclosures remain relevant and comprehensive.

More Consistent, Comparable, And Timely Pillar 3 Disclosures By Banking Groups And Debt-Issuing Bank Subsidiaries Would Benefit Capital Markets

We believe that some banks have significantly increased the amount of Pillar 3 data that they report without improving the quality and relevance of the disclosure. Indeed, some of the narratives we have seen offer little if any valuable insight into banks' risk profiles. We think banks should disclose only that information which is relevant and of an appropriate volume. Based on our observations, Pillar 3 disclosure reports exceeding 100 pages are not necessarily of better quality than shorter reports.

We think Pillar 3 disclosures should be mandatory for all internationally active banks at the group level and for bank subsidiaries issuing debt. At the subsidiary level, the full set of Pillar 3 disclosures is probably unnecessary, in our view.

The focus should be on timely disclosure of capital and leverage ratios, and their key elements: The amount and composition of capital, and the key components of risk-weighted assets (RWAs), including exposures at default analyzed by geography, asset class, and risk type. This is particularly important for subsidiaries because we observe that these data are often omitted from their financial statements. In addition, we think that information organized around key legal entities within a group may become increasingly useful in a world where host regulators are attentive to what is under their supervision. Therefore, we believe that an analysis or a table showing where the capital is located within the group is crucial for market participants to understand the risk profile of banks.

Currently, most banks publish full Pillar 3 disclosure reports once a year, sometimes with a substantial time lag after the publication of their annual financial statements. The proposals to increase the frequency and timeliness are welcome. We support the proposed requirement regarding timing that will require banks to publish Pillar 3 reports concurrently with their financial reporting. While we support semiannual reporting, we generally don't think that quarterly reports are always necessary. We think a timely, in-depth annual Pillar 3 report and a timely half-year Pillar 3 report with less narrative and more of a focus on quantitative disclosure is appropriate. We don't think that quarterly information about standardized or IRB approaches to credit exposures, market risk capital requirements, and securitization in the banking book broken down by ratings is necessary because these figures remain broadly stable over the course of three months.

Nevertheless we recognize that for some exposures the risks could evolve rapidly. This is notably the case for exposure to central counterparties and derivatives, but we think that inclusion of a table in the quarterly financial report is enough. If the Basel Committee decides to move ahead with the proposed requirement for banks to publish Pillar 3 disclosures for certain data as frequently as they report their financials, we hope that it does not lead to the unintended consequence of discouraging banks from publishing quarterly financial reports when their regulators do not require them to do so.

Disclosures That Better Reconcile And Link Pillar 3 Disclosures With Accounting Information Will Enhance Transparency

Tables LI1, LI2, and LIA in the consultative document

Financial statements and Pillar 3 reports are the two most important published sources of financial information about a bank. However, these two sets of data are largely unrelated and independent. To bridge the gap, many large banks now provide reconciliations of accounting capital to regulatory capital, and accounting balance sheets to regulatory amounts--as recommended by the Enhanced Disclosure Task Force (EDTF). These reconciliations are helpful for analysis because they allow for a better understanding of the underlying risk of financial accounting lines, the risk related to off-balance-sheet exposures, the percentage of exposures covered by guarantees and eligible collateral, as well as the level of specific provisions built against exposures. In the absence of such disclosure, it is nearly impossible for users of Pillar 3 reports and financial statements to map regulatory prudential exposures to accounting information.

We support the proposed templates in the consultative document (templates LI1, LI2, and LIA) because they provide a clear, consistent, and comparable format for banks to reconcile quantitative Pillar 3 information to accounting information. However, we believe that the proposed requirements for narrative disclosures that accompany these

templates are too generic and may result in boilerplate disclosures that lack bank-specific detail. In particular:

- In table LI1, the requirement to explain differences between the accounting balance sheet (column "a" of the table) and the regulatory balance sheet (column "b") could be stricter, for example, by requiring banks to set out amounts of the differences that are due to the deconsolidation of insurance subsidiaries, the consolidation of banking subsidiaries, and so on.
- In table LIA, the requirement to explain systems and controls underlying valuation estimates, valuation methodologies, and processes for valuation adjustments appears somewhat generic. In our view, this requirement should include a specific reminder that banks should ensure that the disclosures adhere to the principle that should be meaningful to users and include relevant references to line items on the balance sheet or income statement.

The requirement (in template LI2) to show a specific line item that quantifies the differences between accounting amounts, and regulatory amounts due to prudent valuation guidance can provide insights to the extent of valuation uncertainty. An understanding of valuation uncertainty is an important element in the financial analysis of a bank, as relatively small changes in valuations can have a significant impact on solvency and capital strength given banks' high leverage. Therefore, when analyzing a bank, an understanding of the range of possible values for financial instruments is as important as the single valuation that a bank includes on the balance sheet. In our view, an additional template that shows gross and net balances of impairments and risk mitigation for each class of financial instrument, and quantifies the potential downsides and upsides arising from valuation uncertainty would provide a clear view of the range of plausible fair values--and thus the extent of valuation uncertainty--for each class of financial instrument. We understand that in the U.K., the Prudential Regulatory Authority already requires banks to submit this information in their regulatory reporting. (See "What's Fair Value? Reducing Valuation Uncertainty Could Boost Confidence In U.K. Banks--And Global Peers," March 7, 2013.)

The Proposed Credit Risk Templates Lack Sufficient Granularity In Some Key Areas

Tables CRA, CR1, CR2, CRB, CRC, CR3, CR4, CR5, CR6, CRD, CR7, CR8, CRE, CR9, CR10, CR11, CR12, CRF, and CR13 in the consultative document

The consultative document sets out a number of standardized templates for credit risk disclosures, which in our view represent clear improvements over current Pillar 3 requirements. In particular, the proposed disclosures provide a breakdown between defaulted and nondefaulted exposures, information on allowances, write-offs, off-balance-sheet exposures and protections, as well as back-testing information regarding IRB models. In our view, these are important elements for the analysis of banks; the fixed table formats proposed, as well as consistent and clear definitions of exposures, will significantly improve transparency and comparability about credit risk.

That said, we believe that the proposals could go further to provide more comprehensive information about credit risk to the market. We believe that the following additional quantitative disclosures should be required for credit risk, in standardized, detailed formats:

- Breakdown of credit risk by geography and industry.
- Amounts of impaired exposures (according to the definition in use for accounting purposes) and related allowances and write-offs, broken down by geography and industry.

We note that this information is required as part of the table CRB, but the lack of clear guidelines and a standardized format, as well as the absence of required detail will in our view limit the disclosure's usability. Regarding breakdowns by geography, we believe this should be required by individual country rather than by region where significant (for example, where the exposure in a country represents more than 5% of total exposures). This is because we have seen many Pillar 3 disclosure reports that provide only a breakdown by (large) geographic region. At least for large exposures, this is not enough to understand the risks that banks are facing. For example, within the region "Europe," we see the average risk associated with a Greek corporate entity exposure as far greater than an exposure to an average Swiss corporate entity. Geographic information by country will also provide users with information on the relative concentration of the exposures, which is an important component of a bank's risk profile. In addition, disclosure by region can vary across banks, as the definitions of region can differ, making comparisons more difficult and less meaningful. We would need a tabular presentation of industries by geography--that is, not a separate one of geographies and a second one by industry--so that, for instance, we can see X billion of mortgages in country Y, to properly understand the bank's risk profile. We also believe that a description of the basis of their geographic presentation--country by booking location, client location, etc.--would be useful.

We believe that the proposed level of granularity for asset classes does not entirely fulfill the aims of transparency and comparability. In particular we believe that the following information, as an add-on to the proposals, should be systematically disclosed for both the standardized and the IRB approaches to further improve disclosure reports and allow users to better understand and compare banks' risk profiles:

- Breakdown between listed and nonlisted equity exposures, as well as their fair value and unrealized gains and losses.
- Construction and real estate development exposures.
- Covered bond exposures.
- Auto loans.
- Credit card and qualifying revolving exposures (QRE).
- Breakdown of mortgages, for example between self-certified, buy-to-let, and interest-only mortgages.
- Details on "higher-risk categories."
- Details on "other assets."
- Deferred tax assets (DTAs) that are risk-weighted and not deducted from capital.
- Any equity holdings (investment in common equity of deconsolidated subsidiaries, investment in financials, and interests in joint ventures) that are risk-weighted and not deducted from capital.

In the absence of a detailed breakdown by geography and asset class for both the standardized and IRB approaches, and for the credit risk tables where a detailed breakdown would be useful (tables CR1, CR7 as well as a table that breaks down IRB exposures by asset classes, which is not included in the proposal), we think that some information could be misleading.

For example, table CR4 requires disclosure of protected exposures and coverage ratios, but without a breakdown by asset class, it could be confusing. Indeed, loss given default and risk differs significantly from asset class to asset class, which would imply a different "suitable" coverage ratio. Similarly, with table CR1, the defaulted exposures, allowances, and write-offs would be much more valuable with a detailed asset class and geographic breakdown.

We think the difference in terms of breakdown by asset class requirement between the standardized and IRB approaches might be also confusing. For example, banks using the standardized approach will not be required to disclose RWAs for credit card or QREs as an independent asset class (table CR8)--even though these exposures are usually riskier than other retail exposures--while banks using IRB advanced approaches will be required to do so (table CR10).

We also believe that banks should disclose the same information with the same level of granularity (especially in terms of asset class breakdown) regardless of the approach used. For instance, we note that banks using IRB models will be required to disclose the exposures only by probability of default and not by asset class. We suggest a table showing the exposures under the IRB approaches broken down by asset class, similar to table CR7. We also believe that both tables should include the details mentioned above to allow for better insight into the risk profile of the institution. In addition, to further improve transparency and comparability, clarity about local regulatory add-ons and floors and how they affect RWA would be useful. Similarly, a table showing the risk weights generated by a bank's IRB model based on a standardized portfolio defined by the Basel Committee would be useful in understanding differences in how banks assess the same risks.

In addition, for guarantees, a breakdown by guarantor between sovereign and financial institutions would be useful, as would a breakdown of collateral type by approach and asset class as a complement to the table CR3 but also to all other related tables. This type of risk mitigation information is essential to understand a bank's risk position and understand movements in RWAs.

In our view, disclosures about loan to value ratios are essential, and should be systematically disclosed, at least annually. Information about single-name lending concentrations of banks to financial institutions and corporates would also be useful in assessing their risk profiles. We note that this information is not mentioned in the proposal.

We understand that disclosures regarding capital requirements and capital buffers, which are governed by a previous Basel Committee publication (Composition of capital disclosure requirements, June 2012) will be considered for inclusion in Pillar 3 in the second phase of the review. We hope that because of the two-step process some areas will not fall through the cracks. For instance, we hope the final requirements will offer comprehensive guidance about handling DTAs and deferred tax liabilities, equity stakes and hybrids investments in insurance subsidiaries, investments in deconsolidated subsidiaries, as a result of regulatory treatment that is split between capital deduction and RWAs.

Counterparty Credit Risk Disclosures Should Also Address Differences In The Measurement Of Credit Valuation Adjustments

Tables CCRA, CCR1, CCR2, CCR3, CCR4, CCR5, CCR6, CCR7, and CCR8 in the consultative document

The Basel Committee's proposed tables for the quantitative disclosure of counterparty credit risk will, in our view, significantly improve the transparency and comparability of banks' exposures in this area. The proposed breakdown by asset class and by counterparty for exposures under the standardized approach (table CCR3) would provide important information about the counterparty risks facing banks. We think a similar table under the IRB approach is also needed.

Similar to our aforementioned view about credit risk, we believe that a detailed geographic breakdown, more information on credit risk mitigation (that is, a breakdown by asset class, collateral type, and guarantor) would be welcome to further improve the disclosures.

We believe disclosure about the scope of credit valuation adjustments (CVA) (table CCR2), are needed for comparability. Because of national discretion, in some jurisdictions the CVA includes sovereign, corporate, and financial institution counterparties, while in others it includes only financial institution counterparties.

Securitization Disclosures Are Particularly Weak In Current Pillar 3 Disclosures

Tables SECA, SEC1, SEC2, SEC3, SEC4, SEC5, and SEC6 in the consultative document

We see securitization disclosure as one of the weakest parts of current Pillar 3 reports. Securitization has been under the close scrutiny of analysts and investors since the latest financial crisis. Since then, local and regional regulators as well as international organizations have tried to improve disclosure quality, but these efforts have led to greater complexity and widespread confusion about terminology.

In our view, the key element for securitization exposures is a breakdown by risk weight or by external rating of purchased and retained exposures. In this respect, the proposals are in line with our view and represent a significant improvement. We consider that the suggested standardized tables are very easy to read and adequately summarize the relevant information.

However, we note that the required breakdown by external rating is not very detailed. We suggest disclosing a more detailed breakdown by rating, especially for ratings associated with different risk weights. A breakdown by small risk weight bands as opposed to ratings, especially for the non-rated tranches, would be a suitable alternative. We also note that the breakdown by external rating will be required only for securitization exposures in the banking book. We suggest disclosing the same information for the securitization in the trading book as well.

The Proposed Templates For Market Risk Disclosure Are A Welcome Improvement

Tables MRA, MRB, MR1, MR2, MR3, MR4, and MR5 in the consultative document

In our opinion, banks should systematically disclose back-testing information, risks covered and not covered by their VaR model, the data period used for the models' calibration, and the daily profit and loss through the year--in addition to the regulatory capital requirement broken down by different components. We note that the proposal calls for disclosing all of the above data and information regarding market risk. For comparative purposes, we think that banks should use similar stress scenarios or at least disclose their stress test assumptions. Although many banks disclose the technical details of their market risk models, they are generally of limited use in helping market participants assess a bank's risk profile. The complexity of market risk and the complex value-at-risk (VaR) models that banks use limit the value of the additional VaR details.

In our view, the proposed disclosure templates are much better than existing disclosure. We think that complementary information, such as a list of capital markets where banks are active, the description of major instruments and

strategies, the breakdown of revenues by market type, and the breakdown by internal ratings of specific risk exposures, could contribute further to a better understanding of the underlying risks taken by a bank's capital market division.

Related Criteria And Research

Related criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related research

- Standard & Poor's Response To The EBA Highlights The Shortcomings Of Banks' Pillar 3 Disclosures, March 7, 2013
- The Enhanced Disclosure Task Force: S&P Study Finds That Bank Reporting Has Improved But Still Falls Short, June 26, 2013

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