

Basel's Proposals To Enhance Banks' Pillar 3 Disclosures Are A Welcome Boost For Transparency And Comparability

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Basel's Proposals To Enhance Banks' Pillar 3 Disclosures Are A Welcome Boost For Transparency And Comparability

(Editor's note: The following is S&P Global Ratings' response to the Basel Committee on Banking Supervision's consultative document "Pillar 3 disclosure requirements – consolidated and enhanced framework," issued March 11, 2016. The views expressed in this response represent those of S&P Global Ratings and do not address, nor do we intend them to address, the views of any other affiliate or division of S&P Global. 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.)

In S&P Global Ratings' opinion, the Basel Committee on Banking Supervision's (BCBS) proposed revisions to banks' Pillar 3 reporting requirements address a number of shortfalls in banks' disclosures we have highlighted in the past. We believe that the proposals would allow users to more easily obtain timely information on key risks and exposures in standardized, highly comparable formats. In addition, the BCBS' consultation sets out, for the first time, proposed disclosures on the Financial Stability Board's total loss-absorbing capacity (TLAC) framework for globally systemically important banks (G-SIBs). We think that these disclosures as proposed address many of the disclosure needs surrounding TLAC that we have highlighted previously.

In addition to standardized disclosures on TLAC, the BCBS' recent consultation includes proposals that would require banks to provide: disclosures of hypothetical risk-weighted assets (RWAs) under a standardized approach; a dashboard of key regulatory metrics; and greater granularity of prudent valuation adjustments. In addition, the proposals set out new standardized disclosures for operational and market risk. We view these proposals as another step toward boosting transparency and comparability across banks.

Overview

- The proposal for TLAC includes much-needed disclosure around creditor hierarchies at a legal entity level. However, we think the disclosures would be required well ahead of implementation of the TLAC requirements in order to support investment decisions in a period of substantial TLAC issuance by banks.
- The proposed disclosure of hypothetical risk-weighted assets (RWAs) calculated under the standardized approach and accompanying narrative explanations will contribute both to a greater understanding of RWA variances across banks and a reduction in unjustified variances, in our view.
- Quarterly disclosure of a regulatory key metrics dashboard could be enhanced through the inclusion of hypothetical common equity Tier 1 (CET1) ratios, to complement the disclosure of CET1, the leverage ratio, and other measures. Overall, including a range of regulatory capital metrics would help to provide a more rounded view of a bank's capital position.
- The proposed, more granular disclosures of prudent valuation adjustments to regulatory capital would be of limited use in our analysis. The requirements could be enhanced by disclosure of the valuation ranges of banks' fair-valued assets and liabilities.

Four New Templates For TLAC Disclosures

In our view, the BCBS' proposed TLAC disclosure requirements would go a long way toward addressing the information we would look for in assessing TLAC in the context of our bank ratings.

For S&P Global Ratings, transparency regarding the pecking order of banks' liabilities is essential when assigning debt ratings. For TLAC, therefore, we would look to ascertain:

- Whether the debt outstanding is redeemable, and if so, whether regulators would have to approve the redemption.
- The rolling maturities of all of a bank's liabilities, with particular focus on TLAC, and with additional disclosure beyond one year (for example, redemption of TLAC instruments between 12 and 24 months). This helps to clarify not only why certain liabilities are excluded from TLAC, but also show the amount of issuance needed over the coming year to comply with TLAC.
- The amount of TLAC instruments a bank is holding that can be used for bail-ins of other banks.

We believe that quarterly disclosures for the above would be ideal, with semi-annual disclosure already a satisfactory outcome. We also think that a breakdown of TLAC holdings, both on a consolidated basis and for key subsidiaries individually, would be informative for the market and engender greater stability in a period of stress.

Taking each of the proposed TLAC templates in turn:

Template KM2. The required quarterly disclosures in template KM2 would show, at the level of each resolution entity in a G-SIB:

- Total RWA;
- TLAC/RWA;
- Total leverage exposure measure; and
- TLAC/total leverage exposure measure.

For those G-SIBs with a multiple point of entry approach in resolution, these disclosures would be more voluminous than for those with a single point of entry approach, but nevertheless important for investors as they provide a single, regular information source on the broad elements of TLAC. The volume of disclosure underscores the importance of setting out the information in standardized templates, in our view.

Template TLAC1. This template provides useful information on a number of more qualitative ALAC considerations, including for example:

- Investments in external TLAC issued by other resolution groups within the same G-SIB; and
- External TLAC issued by the resolution group that is held by other resolution groups within the same G-SIB.

Templates TLAC2 and TLAC3. For TLAC, we believe that these templates will be the most useful for investors and to inform our analysis. Both templates set out the pecking order of liabilities, both at material subgroup entity level (template TLAC2) and at resolution entity level (template TLAC3). In addition, the information in these templates would help us to compute our own measure of a bank's loss-absorbing capacity (additional loss-absorbing capacity; ALAC) buffers. It is essential to have a good level of disclosure granularity about TLAC maturities, at least as granular as what is in the current proposal (between 1-2 years, 2-5 years, 5-10 years, and more than 10 years). That said, we

think that the disclosure of TLAC maturities between 2-5 years could be more granular (for example, 2-3 years, 3-4 years, and 4-5 years), to help investors better understand how much debt, if any, needs to be raised each year to avoid a breach of the TLAC ratio.

We note the BCBS' proposal that the TLAC templates would be required from the date that the TLAC rules come into force (currently expected to be Jan. 1, 2019). Given that issuance of TLAC instruments will need to occur between now and that date, we think that the disclosures should be implemented as soon as possible to give investors sufficient information to subscribe to TLAC issuance by banks.

Disclosures Of Hypothetical Risk-Weighted Assets

The BCBS had previously highlighted variations in the way banks measure RWAs using their own internal models, which were not solely attributable to "explainable" factors such as differences in asset mix or supervisory approaches. In addition, since the financial crisis, investors have expressed their concerns about variations in RWAs across banks and the lack of transparency in the drivers of changes in RWAs. In order to reduce the opacity around banks' RWAs and to enhance comparability, the BCBS proposes that banks disclose their hypothetical RWAs—that is, their RWAs calculated based on the standardized approach. This disclosure would be required for RWAs subject to credit risk, counterparty credit risk, and market risk. For operational risk RWAs, there is a separate consultation underway that replaces the current four ways to measure operational risk to a single new option using a new standardized approach.

We believe the proposed disclosures would provide a very useful starting point for comparative analysis across banks. In particular, the requirement for narrative disclosures explaining differences between standardized RWAs and internally modelled RWAs would provide insight into differences in model approaches and assumptions across banks. That said, we think that specifying minimum standards for the narrative could enhance disclosures further. For example, in cases where internally modelled RWAs are much lower than hypothetical RWAs, in our view it would be helpful to set out a requirement for loss rates for the industry as a whole during a crisis period, with management explanations for the key drivers of such differences and any specific changes in that time period (e.g. changes in underwriting).

To complement the disclosure of hypothetical RWAs using the standardized approach, we think that banks should also disclose their hypothetical CET1 (common equity tier 1) capital ratio, given that the calculation of the numerator of the ratio may differ when using standardized RWAs. (This is because, for credit risk, there may be differences in the deduction from capital for expected losses between the standardized approach and internal model approaches.) Otherwise, we consider it likely that investors will erroneously use the actual CET1 capital figure and the hypothetical RWA figure to derive a "standardized" CET1 ratio to compare across banks.

We consider that the proposals lack clarity around the calculation of standardized RWAs—specifically, whether the calculations should be based on standardized approach requirements as issued by the BCBS itself, or the implementation of such requirements by jurisdictional regulators. We think that the calculations should be based on BCBS requirements, as that would best serve the goal of comparability for investors. Otherwise, differences in regulatory approaches and definitions between jurisdictions could undermine the aims of the disclosure.

While we support the disclosure of hypothetical RWAs as a useful development, we think that such disclosures should not be a substitute for enhancements in risk-sensitive internal models. Less risk-sensitive capital measures could drive certain behaviors, especially at a time when low (sometimes negative) interest rates may push banks to go up the risk curve.

Quarterly Key Metrics Dashboard Would Help Highlight Trends

Under the BCBS' proposals, banks would be required to publish a quarterly dashboard of key regulatory metrics, showing (for the current quarter and each of the previous four quarters):

- Total regulatory capital amounts and ratios--disaggregated between CET1, Tier 1 and the total;
- RWAs;
- Additional CET1 buffers as a percentage of RWAs; and
- The leverage ratio, liquidity coverage ratio (LCR), and net stable funding ratio (NSFR).

This standardized, quarterly disclosure will be a helpful, convenient information source for investors and, over time, may start to more easily highlight trends affecting an individual bank or banking industry. Where transitional provisions for Basel III capital rules are in place, we think that there should be separate disclosures for both the transitional metrics and "fully loaded" metrics.

In our view, the proposed disclosure of a range of capital ratios (CET1, leverage, and the hypothetical CET1 ratio as we propose in this article) would help to provide a more rounded picture of a bank's capital position compared with a single ratio in isolation.

For the LCR disclosure, we note that the proposed template requires disclosure of total high quality liquid assets (HQLA). Some jurisdictions have introduced different levels of HQLA (for example, the EU rules distinguish between level 1, 2A, and 2B HQLA), with limits on the proportion of each. We consider that disaggregation of total HQLA into these elements in the disclosure should be required.

Greater Granularity In Prudent Valuation Adjustments Would Not Reveal The Extent Of Valuation Uncertainties Across Banks

Under current Pillar 3 rules, banks already disclose the total prudent valuation adjustment deducted from their regulatory capital. These deductions are intended to reflect valuation uncertainties inherent in many accounting-based fair value measurements. The BCBS proposes that banks disclose a breakdown of this total figure, showing prudent valuation adjustments attributable to, for example, unearned credit spreads and investment/funding costs. The greater level of granularity would be of limited use in our analysis.

Valuation uncertainty can arise because balance sheet valuations of fair-valued assets and liabilities often represent a single value in a range of plausible valuations. While this range is narrow for financial instruments in active, liquid markets with price transparency, it is broader where such markets do not exist (or are illiquid). In addition, fair value ranges and single-point estimates for fair values on the balance sheet may vary widely between banks because of

differences in their underlying judgments and assumptions. That is why we think that quantitative disclosures of the potential downsides and upsides arising from valuation uncertainty would be a more useful disclosure than that proposed by the BCBS. It would provide a clearer view of the range of plausible fair values for each defined class of financial instrument (both assets and liabilities), and provide scope for greater insight of relative valuation risks across banks.

Changes To Pillar 3 Rules Should Be Timely And Responsive To Changes In Investor Needs

We note that a number of the disclosure proposals are dependent on the outcome of other Basel 3 revisions in progress. Therefore the final rules for the related disclosures may change as those revisions are finalized. Nevertheless, we think that the BCBS has adopted the right approach in bringing Pillar 3 rules into a single framework and consulting on them now, as it should mean that the right disclosures are in place in a timely manner.

With the increasing usefulness of Pillar 3 reporting and the welcome move to greater use of standardized templates, we think that electronic versions of Pillar 3 reports could be enhanced by requiring them to be available in a spreadsheet format such as Excel, enabling investors to analyze and evaluate the data more effectively.

Related Research

- All In On Bailing In? The FSB Weighs In, With A Proposal On Global Banks' Total Loss-Absorbing Capacity, Feb. 5, 2015
- Standard & Poor's Supports The Basel Committee's Proposals To Enhance Banks' Pillar 3 Disclosures, Oct. 9, 2014
- U.S. Banks: Government Support Is Fading But Not Gone--Yet, Aug. 4, 2014
- The Enhanced Disclosure Task Force: S&P Study Finds That Bank Reporting Has Improved But Still Falls Short, June 26, 2013
- What's Fair Value? Reducing Valuation Uncertainty Could Boost Confidence In U.K. Banks--And Global Peers, published March 7, 2013
- Standard & Poor's Response To The EBA Highlights The Shortcomings Of Banks' Pillar 3 Disclosures, May 7, 2012

Appendix

Summary Of 13 New Disclosure Templates			
Template name	Summary of information proposed to be included in the template	Proposed frequency	Proposed date of implementation
Key metrics			
KM1	Template disclosing a bank's available capital, RWAs, leverage ratio, LCR, and NSFR.	Quarterly	End-2017
TLAC (for G-SIBs only)			
KM2	Available capital, RWAs, leverage ratio, LCR, and NSFR, at each resolution entity in a G-SIB	Quarterly	Jan. 1, 2019
TLAC1	Composition of capital, including TLAC, at group level and for each resolution group within the G-SIB.	Semiannual	Jan. 1, 2019

Summary Of 13 New Disclosure Templates (cont.)

Template name	Summary of information proposed to be included in the template	Proposed frequency	Proposed date of implementation
TLAC2	Creditor hierarchy at each material subgroup entity in the resolution group.	Semiannual	Jan. 1, 2019
TLAC3	Creditor hierarchy at each resolution entity in a G-SIB.	Semiannual	Jan. 1, 2019
Hypothetical RWAs based on the standardized approach			
HYP1	RWAs calculated under the standardized approach for credit risk, counterparty credit risk, securitization exposures, market risk, compared to the figures used under the internal model approaches used in the calculation of regulatory capital.	Semiannual	Not yet decided
HYP2	As HYP1, but focussed on a more granular analysis of credit risk.	Semiannual	Not yet decided
Prudent valuation			
PV1	A breakdown of prudent valuation adjustments made for fair-valued financial assets	Annual	End-2017
Operational risk			
ORA	Narrative disclosures about the main features of the bank's operational risk management.	Annual	Not yet decided
OR1	10 year historical losses used for the standardized measurement approach (SMA) calculation.	Annual	Not yet decided
OR2	Breakdown of the elements making up the operational risk charge (interest, services, financial).	Annual	Not yet decided
OR3	Last 3 years incurred losses arising from operational risk.	Annual	Not yet decided
Market risk			
MRC	Qualitative information about the structure of a bank's trading desks relevant for the internal model approach.	Semiannual	End-2017

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