

The following article appears in the July/August 2004 issue of Global Risk Regulator (www.globalriskregulator.com):

Problems remain over information disclosure

Does the new capital accord still oblige banks to provide the wrong information to the markets under the pillar 3 disclosure rules? Ray Soifer gives a personal view

The ‘final’ version of pillar 3 in the new Basel capital accord, dealing with information disclosure and market discipline, is much improved from earlier drafts, but still reflects a mistaken belief that market participants will be interested in validating banks’ advanced risk models. That is the job of banking supervisors. It is also too concerned with comparability of disclosures from one bank to another, rather than with reporting that reflects how each bank really manages its own risks.

So precisely how do the latest pillar 3 disclosure requirements compare with those of earlier drafts? Following the Basel Committee’s initial Basel II Consultative Document in 2001, the Centre for the Study of Financial Innovation, a London-based think tank, asked a group of interested observers – industry participants, academics, consultants, etc, none associated with the Committee – for their views on various aspects of the proposed new capital accord. These were published in January 2002 as *Bumps on the Road to Basel: An anthology of views on Basel II*.

As a former brokerage-house equity analyst turned industry consultant, I entitled the chapter that I had been invited to write, *What investors really want to know: thoughts on Pillar 3*. Among these ‘thoughts’ were:

- The Basel Committee assumes that ‘market participants’ – analysts and fund managers – will be sufficiently interested in assessing capital adequacy that they will happily sift through the reams of validation data which the proposed reporting templates then provided.
- However, for these market participants, a bank’s capital adequacy and the accuracy of its risk models are of only marginal relevance, at best, to their investment decisions. What matters more is not the analysts’ opinion, but the determination of banking supervisors themselves. Supervisors have access to banks’ internal data, e.g. credit

portfolios and counterparty exposures on a name-by-name basis, which market participants do not.

- Basel II is primarily about risk measurement. Shareholder value, however, depends on risk management: maximising risk-adjusted return. There should be as strong a link as possible between the framework used by management to evaluate risk and return and the information that is disclosed.

Much improved

The ‘final’ version of pillar 3, in June’s Basel II text, is much improved from that of the original Consultative Document, and even from last year’s Third Consultative Paper (CP3). Not only has the volume of required disclosures been reduced significantly, and the critical role of accounting standards been taken into consideration, but the Basel Committee has, in many cases, heard the views of analysts as expressed to its Working Group on Enhanced Disclosures, and described in its paper of May 2004, *Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis*.

More “meat”

Specifically with respect to credit risk, the analysts who made presentations to the Working Group wanted more ‘meat’ in institutions’ disclosures, notably the breaking down of risk by credit ratings. Pillar 3 will go a long way towards satisfying their needs. In one important respect, however, pillar 3 falls short. Analysts said they wanted more information about concentrations of risk: one analyst, for example, suggested that banks provide the sizes of their ten largest single exposures, perhaps with general descriptions of the risk categories involved (e.g. by industry or geography) but without names. The Committee is continuing to study this issue. It is not a simple one, since in some cases the provision of greater detail, as requested by the analysts, might compromise confidentiality and thus be counterproductive to the goal of preventing or reducing credit loss.

As I noted in 2001, the analysts responding to the Working Group want to see financial institutions provide information that corresponds to the way that management views and manages risk internally, instead of following a rigid format.

Having it both ways

Here, however, pillar 3 tries to have it both ways. Point 810 in the final Basel II document says that “in principle, banks’ disclosures should be consistent with how [they] assess and manage the risks of the bank.” But, then it goes on to say: “Under pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. The Committee believes that providing disclosures that are based on this common framework is an effective means of informing the market ... and provides a consistent and understandable framework that enhances comparability.”

The Committee recognises, at many places in the document, that the actual risk management practices followed by financial institutions may vary substantially from its Basel II framework, in some cases reflecting a more advanced methodology, e.g., incorporating diversification and correlation measures for credit risk, or more sophisticated methods for estimating PD (probability of default) and LGD (loss-given-default) than the ratings-based approaches embodied in its framework. Indeed, at banks that employ RAROC-based (Risk-Adjusted Return on Capital) approaches to risk management, all risk types are blended into a single measure, attributed (not allocated) capital, with which risk levels can be compared and returns computed. Distinctions among types of risk, (e.g. credit risk, market risk, interest rate risk in the banking book) integral to the Basel II framework, are not only irrelevant in RAROC but can be counterproductive, such as by ignoring situations in which market risk can be transformed into credit risk and vice versa.

However, the Committee still insists that banks make their pillar 3 disclosures according to its own category-based format, as set forth in the various tables included in its document, regardless of how risk is actually managed in their institutions.

Not only that, but the Committee is still planning to require banks using the IRB (internal ratings based) approaches for regulatory capital calculations to publish validation data, albeit not as detailed as originally proposed. “The disclosure regime,” it says in point 826 of the Basel II document, “is intended to enable market participants to assess the credit risk exposure of IRB banks and the overall application and suitability of the IRB

framework, without revealing proprietary information or duplicating the role of the supervisor in validating the detail of the IRB framework in place.”

Doing the supervisors’ job

Analysts and fund managers are extremely interested in assessing the risk exposure of *all* banks, whether using the IRB approach or not. But as I noted three years ago, they have no reason at all to care about “the overall application and suitability of the IRB framework.” That, as the Committee goes on to acknowledge, is really the supervisors’ job.

So then, why does the Committee seem to want analysts to look over the supervisors’ shoulders, as it were, when all the analysts want to do is to find bank stocks that will increase in value? Basel Committee members to whom I have posed this question responded that they hope that market participants will add ‘integrity’ to the supervisory process by, for example, comparing the validation data published by banks in different countries and thus helping to achieve a degree of comparability among supervisory regimes. If that is what the Committee wants, my experience as a former analyst suggests it will be disappointed, regardless of how much validation data it forces banks to disclose.

A better way

Fortunately for the future of the international banking system, there is a better way, and it already exists. Through the Basel Committee’s Accord Implementation Group (AIG), supervisors, who already have access to banks’ internal data, can arrange to share the required information among themselves, in all the gory, confidential detail necessary for serious analysis, because it will not be publicly available. For example, the US has had for many years a Shared National Credit Programme, in which syndicated loans and other credits shared by multiple lenders are required, name by name and instrument by instrument, to be rated and provided for identically by all. A similar process deals with sovereign and other transfer risks. If, in an international Basel II context, a given financial instrument were rated a ‘BBB- equivalent’ by banks in Country A and a ‘BBB equivalent’ in Country B, then the AIG would clearly have something to talk about.

Supervisors, such as those in the US and the UK, who host banks from numerous countries and whose own home banks operate in many countries themselves, are well placed to drive such a process and, unlike private-sector analysts, have powerful incentives to do so.

Providing the tools

As the Basel Committee notes in point 811: “Market discipline can contribute to a safe and sound banking environment, and supervisors require firms to operate in a safe and sound manner. Under safety and soundness grounds, supervisors could require banks to disclose information. Alternatively, supervisors have the authority to require banks to provide information in regulatory reports....” A sound approach to implementing pillar 3 would give market participants and supervisors each the tools they need to do what they do best.

Basel II will change the way in which analysts and fund managers evaluate banks’ risk management, comparable to the change that Basel I produced in the evaluation of capital ratios. This process has already begun, and will provide forward-looking banks, and their supervisors, with the opportunity to lead the educational process through which this shift in thinking will come about.

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