Basel II Pillar 3
Market Discipline and Transparency

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Outline of Presentation

• Market discipline and transparency – the theory
• The challenges of achieving market discipline and transparency
• Pillar 3 – principles and content of disclosures
• Hong Kong approach to implementation
• Key practical challenges
Pillar 3: Market discipline / transparency

Three pillars approach

Minimum capital requirements

Supervisory review of capital adequacy

Market discipline
Why Pillar 3?

- **Supplement** supervision through enhanced market transparency and market discipline and hence lever to strengthen system stability
- Allow market participants to obtain key pieces of information on a bank’s capital, risk profile, risk assessment processes and capital adequacy
- Improve comparability among banks especially for those relying on internal methodologies
Market Discipline

- Definition:
  - Disciplinary mechanisms through market forces rewarding banks that are managed effectively while penalizing those whose management is weak or ineffective, thereby strengthening incentives for banks to behave in a prudent and efficient manner.
Types of Market Discipline

- **Direct market discipline** refers to the control or influence market participants have over a bank’s behaviour
  - 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
Preconditions for Market Discipline

- Banks have transparent risk and capital positions
- Market participants have the incentive to process information
- Market participants are able to digest information
- Banks respond appropriately
  - Adjusting pricing, or
  - Adjusting exposures or buffers
Transparency

• Following recent financial crises in various regions of the world, the BCBS and other IFIs have called for increased transparency in banking organisations.
• Banking crises may owe some of their intensity to a general lack of transparency (fact or fiction?)
  – Size of positions of the bank
  – Some practices and policies would not be undertaken by the bank if they were disclosed
How Do We Define Transparency?

- Public disclosure of reliable and timely information
- Enables users to make an accurate assessment of the bank’s financial condition and performance, business activities, risk profile and risk management practices
Ex Ante Effects of Transparency (N.B. Broad Agreement)

- Transparency enhances market discipline
- Transparency increases the sensitivity of the bank’s funding to the risks it takes…incentive to control risks
- At high levels of transparency banks will choose a higher monitoring effort (control their risks); thus, a lower risk profile (lower risk of default)
- Therefore…increased monitoring is assumed to be associated with a lower probability of failure
Ex Post Effects of Transparency (N.B. Differing Views)

**Pros**

- May limit contagion to other banks
  - Depositors and creditors can distinguish between banks that are insolvent and those that are sound
Ex Post Effects of Transparency (N.B. Differing Views)

Cons

• Market responses may exacerbate the position of a bank that is suffering from temporary and recoverable weaknesses caused by exogenous shocks

• Market responses more accentuated when more information is provided
  – Creditors require higher yields, thereby compounding the problem
Tangible Benefits for the Financial System

• Less disruption in the markets if information flows are regular and timely (lack of information breeds uncertainty)
• Disclosure help limit systemic crises by allowing market participants to determine which banks are vulnerable and which are not
• Disclosure strengthens the control of shareholders over management (a wider group of shareholders is able to participate in the governance of the bank)
• More efficient allocation of capital in the system
Goals of Disclosure

• Information disclosed should result in appropriate transparency (achieving transparency)
• Market should respond such that it rewards banks that are well managed (achieving market discipline)
Achieving Transparency (Challenges)

• Certain information is subject to imprecision (e.g., impairment in the loan portfolio)…thus differences may arise among banks

• Qualitative information (e.g., about risk management practices) can be difficult to communicate in a meaningful manner; hence, difficult to make transparent

• Comparability across countries is difficult to achieve (interdependencies between accounting, legal, fiscal and political considerations)
Achieving Transparency (Challenges)

- Confidentiality prevents disclosure of all information that may be relevant to an assessment of a bank’s activities and risk exposures
  - Need to strike a balance between the need for information to assess the quality of risk management and proprietary data
- Usefulness of data depends upon how current it is
Achieving Market Discipline (Challenges)

- May not be able to assume that market participants will take measures to promote safety and soundness based upon information disclosed.
- Do governments allow non- or partial disclosure in times of stress? If yes, the market may turn to other sources of information (e.g., rating agencies, media, and rumors).
- Safety nets reduce the value of disclosures.
- Ability of the market to understand disclosures.
Achieving Market Discipline (Challenges)

- Different risk tolerances among market participants (some participants may want to benefit from extreme upside potential)
- Incentive structures may not be properly aligned (eg, remuneration packages that encourage risk taking...no longer-term incentive for soundness in the bank)
Potential Drawbacks

• Public may react more harshly than is desirable from the viewpoint of authorities who have a responsibility to protect deposits and managing systemic risk; thus…

• The bank could fair for liquidity reasons even if it is still solvent

• Market’s lack of confidence can spread to other banks leading to a systemic crises

• Costs?? For well managed banks, much of the relevant information should already be available internally and used by management to operate the institution
Purpose of Pillar 3

• All three pillars are mutually reinforcing; as such, Pillar 3 is a complement to Pillars 1 and 2

• Disclosure requirements allow market participants to assess key information relating to:
  – Scope of application
  – Capital
  – Risk exposures
  – Risk assessment process

• Particularly relevant because internal methodologies allow banks discretion in assessing capital requirements
Purpose of Pillar 3

- Disclosures should be consistent with how management and the board assess and manage risks.
- Pillar 3 disclosures based upon Basel II framework inform the market about a bank’s exposure to risk in a consistent and understandable manner (i.e., enhanced comparability).
Achieving Appropriate Disclosures

- Supervisors have different powers available to achieve disclosure requirements
  - Disclosure on safety and soundness grounds
  - Disclosure of regulatory reports
- Mechanisms to enforce requirements
  - Moral suasion (to change behavior)
  - Enforcement actions
  - Financial penalties
- Nature of exact measures will depend upon legal powers of the supervisor and nature of any deficiency
• Disclosures should be made on a semi-annual basis
  – but information on broader issues (e.g. a bank’s risk management function) could be provided annually
• Large internationally active banks (and other significant banks) must disclose Tier 1 and total capital ratios and their components on a quarterly basis
• More generally, banks encouraged to disclose information that is subject to rapid change on a quarterly basis
Disclosure Methodology

• Accounting disclosures can be used to satisfy Pillar 3 requirements (but are not a substitute)
• If not disclosed under accounting rules, disclosures may be made through other means – such as via the internet or via the public portion of regulatory reports filed with the supervisor
• Pillar 3 disclosures are not required to be audited by an external auditor unless they are part of accounting disclosure requirements or other disclosure regimes (eg listing requirements)
General Disclosure Principle

- Banks should have a formal disclosure policy approved by the board of directors
  - What disclosures and internal controls over disclosure process
  - Assessment of appropriateness of disclosures and validation, frequency
Scope of Application

- Applies at the top consolidated level to which the Capital Accord applies.
- Individual banks within the groups are generally not required to fulfill disclosure requirements.
- Focus of Pillar 3 is intended to reflect the level of consolidation where effective market discipline will operate.
- National supervisors have discretion to require disclosures at a sub-consolidated level.
- Disclosures provide context for the disclosures on capital and risk exposure.
Scope of Application

- Qualitative Disclosures
  - Name of the top corporate entity to which the Accord applies
  - Description of difference in accounting consolidation and regulatory consolidation with a description of entities in the group that are consolidated, deducted, neither consolidated or deducted (i.e. risk weighted)
  - Restrictions or impediments to the transfer of funds or capital within the group
Scope of Application

- Qualitative Disclosures
  - Aggregate amount of surplus capital in insurance subsidiaries included in capital of the consolidated group
  - Aggregate amount of capital deficiencies in all subsidiaries not included in consolidation (i.e. that are deducted)
  - Aggregate amount of total interests (e.g. current book value) in insurance entities which are risk weighted rather than deducted from capital
Capital

Capital Structure

• Qualitative
  – Terms and conditions of all capital instruments, especially innovative capital instruments
• Quantitative
  – Amount of T1 and its components
  – Total amount of T2 and T3
  – Deductions from T1 and T2
Capital

Capital Adequacy

• Qualitative
  – Discussion of a bank’s approach to assessing adequacy of capital

• Quantitative
  – Capital requirements for credit risk
  – Capital requirements for operational risk
  – Capital requirements for market risk
  – Total and T1 capital ratio for top consolidated group and significant bank subsidiaries
Risk Exposure and Assessment

- General qualitative disclosure requirement
- Credit risk
- Equities in the banking book
- CRM techniques
- Asset securitisation
- Market risk
- Operational risk
- Interest rate risk in the banking book (IRRBB)
Hong Kong Disclosure Rules

• Will replace Financial Disclosure Guidelines
• Represent minimum disclosure standards that HKMA expects of banks
• Apply to all Disclosure Statements for the interim or annual reporting period beginning on or after 1 January 2007
DRs Key Elements (1)

- Apply both to Hong Kong incorporated AIs and overseas AIs (covered by separate section of DRs)
- De minimis exemption for small RLBs or DTCs - only 52% of foreign AIs and 55% of local AIs will be subject to DRs
- But 94-5% of system assets will be covered
DRs Key Elements (2)

- Consolidated group level disclosure on the basis of consolidation for capital adequacy purposes
- Semi-annual and Annual disclosures – but many disclosures only required annually
- Proprietary and confidential information protected
- Clearly defined disclosure policy
- Material information only
DRs Key Elements (3)

- No audit of disclosures unless otherwise required by accounting or other statutory requirements
- May rely on disclosures under accounting or listing requirements
- Allow summary disclosure with full disclosure on bank’s internet website
- May rely on group-wide disclosure by overseas parent subject to certain specified conditions
Key Practical Challenges

• Relationship of Disclosure Rules to IAS—some overlap with accounting requirements

• Definitions/interpretation issues and potential inconsistency arising from accounting changes

• Reporting burden – different reporting requirements by IAS and Pillar 3

• “Materiality”, “Auditability” and “Proprietary and confidentiality”
Consultation Process

- Discussion with equity analysts and rating agencies
- Informal consultation with banking industry, accounting profession and members of Stock Exchange and SFC (Joint Technical Working Group)
- Industry-wide consultation - Disclosure Rules Consultation Paper
- Statutory Consultation on Disclosure Rules
Concluding Remarks

Improved disclosures by banks should facilitate

• Market discipline
• Contribute to supervisory monitoring efforts
• Enhance the stability of the national and international banking systems
• Benefit banks with robust risk management systems (reduce capital buffer against unforeseen risks)