EBA European Banking Authority
European System of Financial Supervision

13 October 2011

Follow-up review of banks' transparency in their 2010 Pillar 3 reports

Executive summary

The assessment of the 2010 Pillar 3 disclosures differs from the previous two reviews in the following respects:

- The scope of our review was limited, e.g. not all Pillar 3 disclosures were assessed against the requirements of the Capital Requirements Directive (CRD). The change in scope followed the EBA's decision to focus on areas where our previous review showed that improvements were necessary.
- In addition to the findings of our analysis, our report also includes some observations on how banks dealt with the interactions between International Financial Reporting Standards (IFRS) and Pillar 3 requirements in the specific disclosure areas considered.

The results of the analysis performed on a sample of 20 banks confirm that banks have made efforts to improve their disclosures and to convey their risk profile in a comprehensive way to market participants. In all areas under review, we have identified best practice disclosures, which we have included in this report, and we encourage credit institutions to follow them.

The EBA welcomes the reduction in the time lag between the publication of the annual report and the publication of the Pillar 3 information. In addition, most of the banks published their reports earlier this year, although there was significant diversity in the Pillar 3 report publication dates.

With regard to the new disclosures on remuneration policy and practices, there is room for significant improvements for the majority of banks included in the sample, and a need for better description of linkages between remuneration practices and the overall risk framework.

Some of the findings included in our 2010 report calling for further improvements remain valid. However, they apply to a reduced number of banks or concern specific requirements of the CRD, such as quantitative back-testing information for credit risks, information on counterparty credit risk covering the issue of wrong-way risk, and sensitivity analysis of interest rate risk.

Further efforts are necessary regarding the interrelationship between IFRS and Pillar 3 disclosures with a view to enabling users to gain a better understanding of the overall profile of the bank as provided by both accounting and prudential information.

However, the main concern remains the need for greater harmonisation of the disclosures provided by the firms. The ESAs, and the ESRB even more so, would benefit from improved timeliness and greater comparability or some standardisation in the presentation of public data.

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1. Introduction and background

Market discipline is based on the assumption that a sound and well-managed bank disclosing high-quality information about its financial situation, exposures and risk management practices will benefit in the form of a reduction in its cost of capital. Accordingly, disclosure requirements aim, indirectly, at fostering sound, prudent and efficient management through market approval. Well-informed market participants will exert pressure on those banks whose disclosures are insufficient or inappropriate. Markets, therefore, provide a check on banks' risk-taking activities which thus acts as a form of self-regulation.

As such, market discipline – the third pillar of the capital framework – complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) and enables market participants to assess the capital adequacy of a bank through key pieces of information on capital, risk exposure and the risk assessment process.

Transparency of a firm's capital resources and requirements has become even more important, given the increasing pressure on the financial institutions to identify, manage and value their risk exposures correctly, especially in times of stress.

This report continues a body of work carried out on an annual basis since 2008[1] by the predecessor of the European Banking Authority (EBA), namely the Committee of European Banking Supervisors (CEBS).

While the June 2010 report noted welcome improvements compared with the findings of the first review, it also highlighted the following areas where improvements were still necessary:

- detailed information on the composition of own funds;
- quantitative back-testing information regarding credit risk;
- clearer information on credit risk mitigation techniques supplemented by adequate quantitative information on their impact; and
- valuation methodology used and detailed quantitative information on credit derivative instruments.

CEBS committed itself to continue monitoring banks' Pillar 3 disclosures, in particular banks' compliance with the relevant requirements in Directive 2006/48/EC, which have been expanded in specific areas and now include requirements aimed at both adequate disclosures reflecting an institution's risk profile and additional disclosures in the areas of securitisation and re-securitisation (applicable from 31 December 2011 onwards), plus new requirements regarding remuneration policies (applicable from 1 January 2011 onwards).

The EBA has taken on CEBS's commitment to assess banks' Pillar 3 disclosures which is reflected in its 2011 work programme. In addition, the EBA intends to assess Pillar 3 disclosures as one of its regular tasks.

2. Objectives and methodology

In previous years, the objective of the report was to assess the compliance of Pillar 3 disclosures provided by credit institutions with the requirements in Title V of

[1] In June 2010, CEBS issued its latest follow-up assessment of banks' 2009 Pillar 3 disclosures: http://www.eba.europa.eu/documents/Publications/Other-Publications/Others/2010/Transparency_Pillar3.aspx. This latest analysis was based on a sample of 24 European banks with cross-border activities and followed a first assessment of 2008 Pillar 3 disclosures (published in June 2009): http://www.eba.europa.eu/getdoc/6efe3a55-b5c5-4f73-a6af-a7b24177e773/CEBS-2009-134-Final-published-(Transparency-assess.aspx.

Directive 2006/48/EC, Chapter 5 – the disclosures framework - and Annex XII's detailed requirements on disclosure.

The focus of this year's analysis has been narrowed down to assessing compliance in those areas needing more improvements according to the June 2010 report and compliance with the new Pillar 3 requirements applicable from January 2011 onwards (Pillar 3 remuneration requirements).

Therefore, this report focuses on the following disclosure areas:

- scope of application
- own funds
- Internal Rating Based approach
- counterparty credit risk
- credit risk mitigation techniques
- securitisation
- interest rate risk
- remuneration requirements

Where relevant for the disclosure area discussed, we have placed some emphasis on the interaction between Pillar 3 and IFRS 7 requirements with a view to initiating discussion on this basic issue. The two previous reports indeed noted that due to the overlap between Pillar 3 and IFRS 7 disclosure requirements, users could benefit from adequate explanations in banks' Pillar 3 disclosures to understand the differences between these two sets of requirements (for example by including reconciliation tables).

In line with past reports, this report continues to identify best practice disclosures with a view to promoting comparability and peer group analysis between banks. A best practice disclosure is a disclosure that stands out by going beyond compliance with the letter of the CRD requirements, or a disclosure that depicts in a very meaningful and useful way the disclosure referred to in the CRD requirements. It should however be stressed that best practice examples are not intended to be exhaustive or exclusive. Rather, they are considered to be particularly useful and conducive to increasing comparability.

Compared with the previous year, the assessment was based on the Pillar 3 disclosures of a slightly adjusted sample of 20 European banks with cross-border activities (see Annex I). Our assessment methodology involved both an analysis at individual bank level carried out by national supervisors, and a cross-entity analysis at disclosure area level carried out by dedicated small teams comprised of two or three national supervisors.

National supervisors discussed the final assessments and scores individually with the institutions covered in the assessment. This provided direct and immediate feedback on the outcome of the analysis and also gave the supervisors an opportunity to understand any specific issues facing particular banks.

This approach aimed to reduce potential bias implicit in any assessment and to promote greater consistency in our assessment of the banks sampled. However, it is essential to note that judgement is inherent to the nature of the exercise.

To reduce this potential bias even more, the assessment methodology was further refined compared with the previous year, this being mainly in terms of the scoring approach which focused this year on strict compliance with CRD requirements rather than how appropriate the disclosures were overall. That means that a disclosure

received an ‘adequate’ score only when all disclosure items per area considered had been provided.

The scores were thus distinguished as follows:

- n/a = item is not applicable;
- 0 = no information provided (if information is regarded as immaterial, proprietary or confidential, the score should be n/a);
- 1 = insufficient information provided (disclosure is non-compliant)
- 2 = sufficient information provided, but disclosures could be improved (disclosures are largely compliant but some aspects are missing);
- 3 = disclosure is adequate (compliant with CRD requirements);

  3* designates disclosures that are compliant with the letter and the spirit of CRD (and often go beyond these requirements or disclose information in a meaningful and useful way, thus being regarded as best practice disclosures).

As a result of this new focus, a score of 3 means that a bank’s disclosure complies with all the CRD requirements deemed to be applicable [2]. Appropriate and extensive/detailed disclosures can therefore be awarded a score of 2, despite their intrinsic quality, if one or some disclosures required in the CRD and deemed by the supervisor to apply for the bank in question have not been provided. However, a disclosure area with a score of 2 does not exclude the disclosure in this area being regarded as an example of best practice.

3. General observations

The complementary character of Pillar 3 and the nature of market discipline lead many supervisors to adopt a non-prescriptive approach regarding practical aspects of information publication, including, for example, timeframe, presentation and location.

3.1. Timeframe and frequency

Publication timeframe

The CRD does not set a specific deadline for publication of Pillar 3 disclosures, but rather expects financial institutions to publish them as soon as practicable. However, the CRD does allow supervisors to set deadlines for publication.

In practice, national supervisors of four countries (from the total of ten countries participating in the assessment) do impose specific deadlines. These range from the publication date of the annual report, to one month after the publication of the annual report at the latest. As a result, little time elapsed in many cases between the publication of the Pillar 3 report and the publication of the annual report. However, three banks published their Pillar 3 disclosures eight to fourteen weeks after the publication of their annual reports.

The actual publication dates of Pillar 3 disclosures varied significantly between the banks in the sample, ranging from the end of February 2011 for banks providing Pillar 3 disclosures in the annual report, to the beginning of June 2011. Overall, banks published their Pillar 3 reports earlier this year as illustrated in the graph below:

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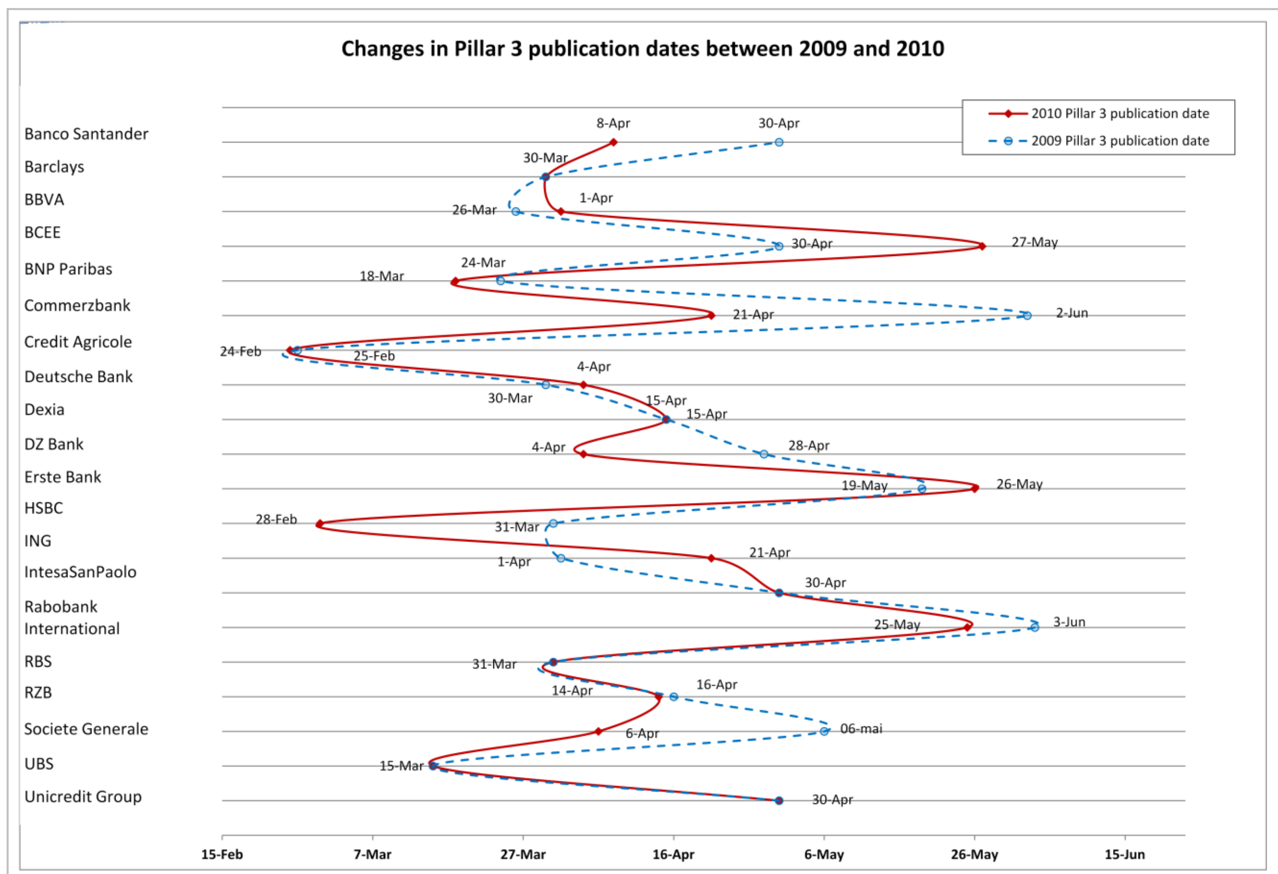
[2] This does not necessarily mean that every single number in the disclosures is correct since the EBA has not verified the content of Pillar 3 disclosures.



The EBA continues to encourage banks to reduce further the time between the publication dates of the annual report and the Pillar 3 information.

Publication frequency

The CRD requires Pillar 3 disclosures to be published annually at least. Some supervisors – for example in Italy and Switzerland - require their banks to publish certain quantitative disclosures and significant changes to qualitative information more frequently. In practice, many banks provide prudential information in their quarterly communication to the market and this is considered a best practice by the EBA. One bank included in the sample even published its Pillar 3 disclosures twice a year on a voluntary basis (DZ Bank).

3.2. Presentation and location

Presentation

The majority of banks (around 70%) included in the sample produced a stand-alone Pillar 3 report. Some banks (around 15%) presented their Pillar 3 disclosures in their annual reports. The other banks opted for a mixed approach by producing a separate Pillar 3 document with various cross-references to the annual report. The distribution of banks across these categories did not change compared with the previous year[3].

Each presentation format has its pros and cons, as discussed in the CEBS 'Follow-up review of banks' transparency in their 2009 Pillar 3 reports'. In line with that review, the EBA does not want, at this stage, to advocate one specific type of presentation, as long as banks provide the complete set of Pillar 3 disclosures to users and clarify the links between the annual accounts and the Pillar 3 information. This implies the use of

[3] Calibration on last year's sample.

clear and unambiguous cross-references. However, in the medium term the EBA, and the ESRB even more so, would benefit from improved timeliness and more comparability across this public data, or some standardisation in its presentation.

Location

The CRD only requires Pillar 3 information to be publicly disclosed. All the banks included in the sample have published the Pillar 3 disclosures on their website, which is now the best way to make information easily accessible. However, for some banks, the exact location of the Pillar 3 disclosures is not clear and may require better signposting. This applies especially to banks publishing their Pillar 3 disclosures in the annual report. A clear reference or link to the document (or to the Pillar 3 section in the annual report) would help the reader to find the Pillar 3 information.

Regarding the new disclosure requirements on remuneration, most banks provide a separate 'Remuneration Report' or similar stand-alone document. This is the case for nine out of the fifteen banks in the sample which have provided these disclosures so far. The remaining six banks included the disclosures either in their annual report or in the Pillar 3 Report, with one bank including the disclosure in its Corporate Governance Report.

Information on remuneration is, however, part of the Pillar 3 disclosure requirements, Accordingly, special attention should be devoted to the risk implications of the remuneration process (see also paragraph 153 of the CEBS's *Guidelines on Remuneration Policies and Practices,* December 2010[4]). Publication of such disclosures in the Pillar 3 Report (or separately, but clearly cross-referenced to that report) could promote their risk-orientation. Disclosure of such prudential information elsewhere (due, for example, to national requirements) could impair a user's understanding of how remuneration practices have been incorporated in an institution's risk strategy.

It is noted that publication of remuneration disclosures as a CRD requirement is foreseen, for the first time, by the end of 2011, based on 2010 year-end data. Four banks in the sample (Erste Bank, Rabobank, ING and RZB) had not published their remuneration disclosures at the time this assessment was carried out. One bank (BCEE) is a state-owned company whose remuneration policies and practices are strictly governed by a law specific to the organisation and are subject to approval by the government. As such, this bank does not have to publish specific remuneration disclosures. The conclusions included in the current analysis should be regarded as related only to the other banks in the sample.

Other considerations

Although nothing is said in the CRD on the matter, the EBA considers that for internationally active banks, providing an English translation of Pillar 3 information would allow a wider range of stakeholders to access the information. It was noted that one of the banks in the sample did not provide such a translation. In addition, a number of banks had not (yet) provided an English version of their disclosures on remuneration.

3.3. Formal disclosure policy and verification of the disclosures

Disclosure policy

The CRD requires financial institutions to set up a formal policy to comply with Pillar 3 disclosure requirements. The EBA considers it best practice for banks to provide

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[4] CEBS's Guidelines on Remuneration Policies and Practices : http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf

information on this disclosure policy, highlighting in particular the policies they have adopted for assessing the appropriateness of their disclosures, the mode of verification and the frequency of disclosure.

Some banks had made efforts in this respect; about half of the banks in the sample are now providing information on their disclosure policy

Verification of disclosures

According to Article 149(d) of the CRD, Member States shall empower the competent authorities to require credit institutions to use specific means of verification for the disclosures not covered by statutory audit.

In all countries but one[5], Pillar 3 disclosures do not have to be audited by an external auditor. Two banks (Intesa and BBVA) have had their Pillar 3 disclosures audited by an external auditor on a voluntary basis (i.e. audit work performed gives reasonable assurance).

3.4. Other presentational aspects

Most of the conclusions in the CEBS 'Follow-up review of banks' transparency in their 2009 Pillar 3 reports' are still valid (see Section III.5 of the June 2010 report).

4. Findings on specific areas of focus (identified in previous assessments)

4.1. Scope of application and own funds

4.1.1. *Scope of application*

As noted earlier, the sample of our assessment comprised banks with cross-border activity, most of them (if not all) therefore having a group structure. Owing to their nature, Pillar 3 disclosures are required on a consolidated basis following the prudential rather than the accounting scope of consolidation. However, information that allows reconciliation of the prudential scope to the accounting scope aims at conveying the global risk picture and, more specifically, the risks posed by the non-banking financial activities of the group (i.e. insurance) and equity participations in non-financial sectors.

Most banks provided more or less detailed narrative information on such differences of scope, albeit without any quantification of their impact. Moreover, some banks limited their disclosure to a theoretical presentation of the differences of scope foreseen by their respective scope of consolidation, without clarifying whether these applied to the bank itself

On the other hand, some banks provided the list of entities excluded from the prudential scope or, conversely, the complete list of entities included in the prudential scope (or sometimes even both lists). In the context of banking groups, this information significantly improves transparency and can thus be considered a best practice disclosure.

In a few cases, the scope (either the prudential scope provided in the Pillar 3 disclosures or a reference to the accounting scope in the annual report provided with the explanation of the differences) was not disclosed.

[5] In Germany, where an external audit of the processes used to determine and disclose Pillar 3 information (not equivalent to verification of the content) is formally required. In Austria, the external auditor is required to perform similar tests, but in the broader context of reviewing the bank's overall control environment, thus including procedures to comply with the Basel capital requirements. The results of this audit work are however not disclosed to the public, but only to the national supervisor.

Many banks did not provide information on i) possible impediments to the transfer of own funds within the group, ii) the aggregate amount by which actual own funds are less than the required minimum in all subsidiaries not included in the consolidation (and the name or names of such subsidiaries), and iii) how/when waivers for solo supervision were used. Though the absence of such information may be explained by the fact that this requirement did not apply to the bank concerned, the EBA considers it best practice to provide an affirmative statement where a bank is not exposed or where information is not applicable (for example, the use of waivers).

Interrelationship between IFRS and Pillar 3 disclosures

Following our thematic study aimed at exploring the extent of the overlap between the Pillar 3 information and the disclosure requirements in IFRS, we restate the need for banks to provide an adequate explanation in their Pillar 3 disclosures regarding any differences in the scope of consolidation for accounting and regulatory purposes to provide users with a better understanding of the relationship between accounting and prudential information.

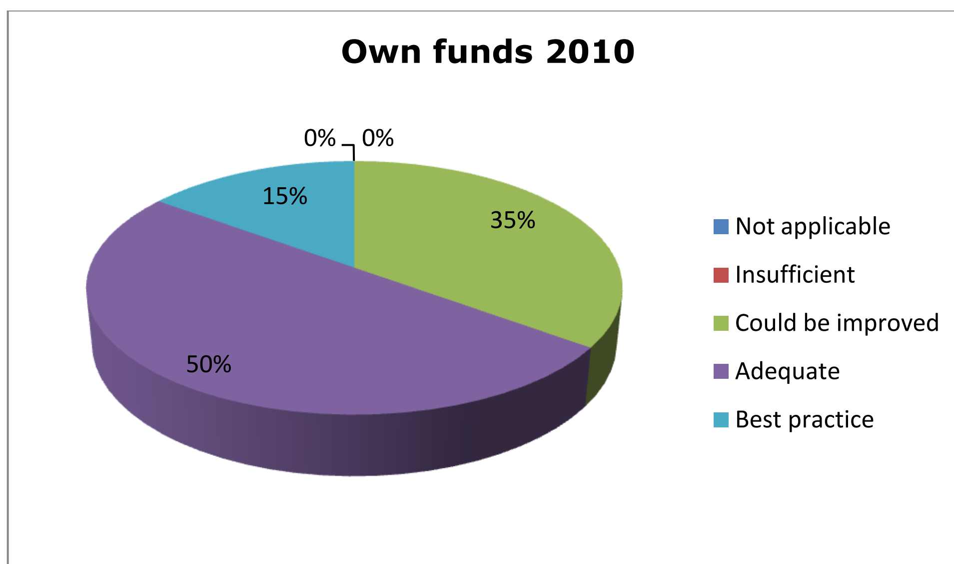
The EBA encourages banks to enhance their disclosures on the scope of consolidation by providing:

- educational information explaining why the scopes differ;
- some quantitative and qualitative elements to assess the significance of the differences;
- references to reconciliation tables or explanations where accounting information and prudential information overlap and where differences of scope result in mismatches between similar types of information disclosed in Pillar 3 reports and annual reports (or in the annual report when Pillar 3 disclosures are not presented in a separate report);
- information on the changes in the scope of consolidation where significant (or alternatively a cross-reference to the annual report).

4.1.2. *Own funds*

As regards disclosures on own funds, a reasonable majority of banks (65%) fared well in terms of strict compliance with CRD requirements.

In this area, several banks made noticeable efforts compared with the 2009 Pillar 3disclosures. More specifically, many banks provided a reconciliation between IFRS accounting equity and prudential own funds as recommended by the EBA in last year’s report and, generally speaking, the disclosures regarding own funds appeared more granular. As a result, the proportion of banks providing either adequate disclosures or best practice disclosures increased from 40% in 2009 to 65% in 2010.



There was however a variety in the level of detail provided by banks:

- Not all banks provided a disaggregation of all items and deductions. Whilst the CRD requirements remain ambiguous, since the Directive states only that 'all positive items and deductions' must be disclosed separately, the EBA is in favour of disaggregation of both positive items and deductions and believes that banks should also adopt this reading of the CRD requirements; most of them already do.
- Many banks did not disclose the IRB provision excess or shortfall on a separate line.
- Terms and conditions for hybrid instruments were not always complete (e.g. disclosures of terms and conditions for hybrid instruments included in Tier 1 but not for the other hybrid instruments like subordinated debt included in Tier 2). Additionally, in some cases the amounts disclosed in the annual report (not always cross-referenced) did not fit perfectly with the prudential amounts retained for the calculation of Tier 1 and Tier 2 capital, with the differences remaining unexplained.

The EBA also noted limited comparability between banks in the following areas:

- The limited level of detail provided by some banks does not allow users to make the necessary adjustments (related to differences in national regulations) and to understand the big picture.
- Banks using the same concepts differently may be a source of confusion. In particular, some banks used Tier 1 as being equivalent to original own funds prior to deductions, while some others used it as being equivalent to original own funds after deductions. This observation also applies to Tier 2. In a few cases the notion of 'core capital' was used as equivalent to Tier 1 capital while, in most cases, core Tier 1 was presented as a subset of Tier 1 capital, anticipating the Tier 1 notion in Basel III. The development and use of common definitions could probably help to address such differences.
- The use of the grandfathering option with regard to the deduction of participations in insurance companies was rarely mentioned, resulting in the risk of comparing one bank's Tier 1 ratio including the deduction with another bank's Tier 1 ratio excluding the deduction.

The EBA identified the following best practice disclosures:

- a description of the changes related to the application of CRD II (Intesa, mentioned in DZ Bank);

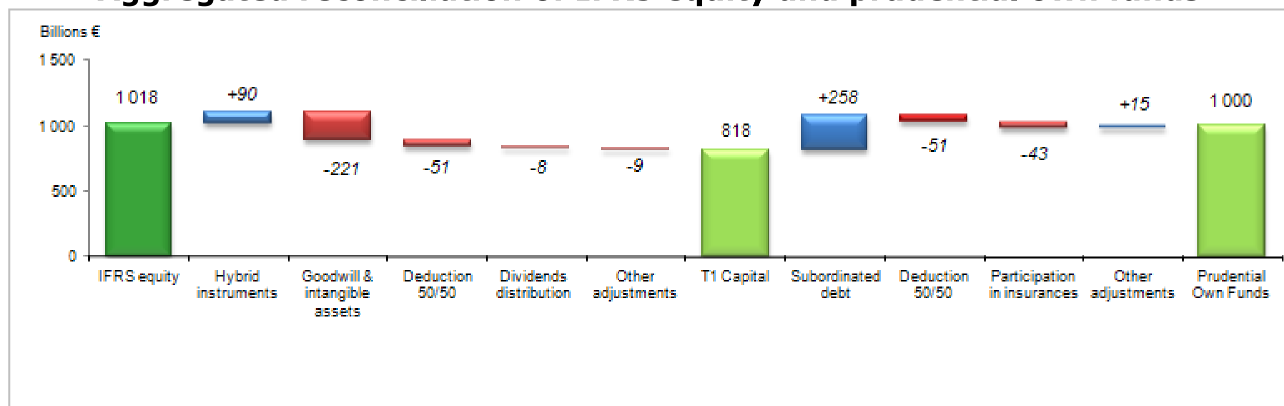
- clear disclosures regarding the reconciliation between IFRS equity and prudential own funds (Société Générale, Deutsche Bank, UBS, Intesa);
- informative disclosures on regulatory capital and its components (core Tier 1, Tier 1, Tier 2 and Tier 3, if any) (Dexia, Intesa, Commerzbank, Deutsche Bank);
- comments on changes compared with the previous year (UBS, Santander); and
- a direct link between the capital structure and capital ratios (HSBC, ING) – the information on capital ratios could also be presented in the section on capital adequacy.

Interrelationship between IFRS and Pillar 3 disclosures

Prudential own funds and IFRS equity are built around two different objectives. While IFRS equity reflects the net worth of the entity, prudential own funds aim to measure the capacity of the bank to cope with unexpected losses and, as such, they appear in the numerator of the solvency ratio.

An aggregated reconciliation of IFRS equity and prudential own funds for the 20 banks included in the sample is illustrated in the graph below:

Aggregated reconciliation of IFRS equity and prudential own funds



Overall, the amounts of prudential own funds are rather close to IFRS equity (EUR 1 018 billion versus EUR 1 000 billion). However, this does not adequately reflect the offsetting effects of various regulatory adjustments.

Tier 1 capital, a reference measure widely used by market participants, is 20% lower than IFRS equity.

This is explained by the following regulatory deductions:

- goodwill and intangible assets;
- accrued dividends;
- Non-consolidated investments in the financial sector, positive differences, if any, between the expected loss on advanced IRB approach portfolio and general accounting provisions, expected loss for equities, and first loss positions from securitisation positions; (these are deductions from Tier 1 and from Tier 2 on a 50/50 basis).

The deductions are partially offset by hybrid instruments eligible for Tier 1, in particular certain deeply subordinated instruments and preferred shares.

Other hybrid instruments which comprise undated (upper Tier 2), dated (lower Tier 2) and short-term (Tier 3, if any) subordinated debts are also included in the prudential own funds.

The amount of total regulatory own funds is arrived at by making deductions for

investments of more than 20% held in insurance affiliates. Regarding the latter deductions, it should be noted that, due to grandfathering provisions, banks adopted different approaches:

- a majority of banks deducted the total amount directly from total own funds;
- some others deducted it from Tier 1 capital;
- Finally, a few banks also deducted part of their investment in insurance companies equally from Tier 1 and Tier 2 and as such included the deduction in the 50/50 deductions.

Depending on the specific circumstances for each bank and the local regulations, the regulatory adjustments known as prudential filters may be positive or negative and be more or less significant. However, this information on prudential filters was not always available.

The reconciliation between IFRS equity and prudential own funds enables users to get a better understanding not only of the composition of prudential own funds, but also of the way they interrelate with IFRS equity.

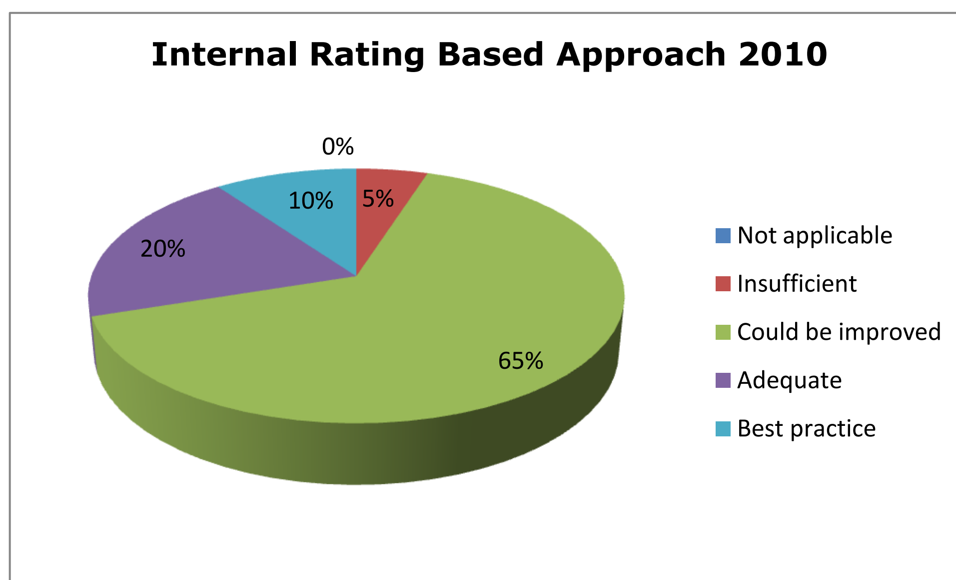
In practice, a quarter of the banks provided a specific reconciliation table. A few others used IFRS equity as the starting point when they presented the breakdown of prudential own funds. However, for a large majority of the banks in the sample, the reconciliation between IFRS equity and regulatory capital was not fully transparent.

In the context of the incoming Basel III regulation – and its planned transposition at EU level by means of the recently published CRD IV/CRR (Capital Requirements Regulation) proposals – full reconciliation between IFRS equity and prudential own funds will become mandatory as of January 2013. According to the EU Commission's proposal, the EBA will have to deliver a template for these disclosures.

4.2. Credit risk

4.2.1. *Internal Rating Based approach*

Setting aside the requirements regarding back-testing, the majority of banks fared quite well in terms of compliance with CRD requirements.



The proportion of the disclosures which 'could be improved' or were 'insufficient' amounts to 70% but would fall to 30% if compliance with back-testing disclosure requirements is not taken into account.

The degree of detail provided about the internal rating structure and processes varied significantly between the banks analysed:

- many banks did not provide any great detail on the specifics/characteristics of their models by exposure classes;
- the relationship with external ratings was often mentioned but not always explained (i.e. comparative tables and/or accompanying text were not always provided); and
- a minority of the banks provided information on definitions, methods, data and assumptions used for the estimation and the validation of parameters.

Although comparability of quantitative information amongst banks appears limited, most of the banks under review did provide adequate quantitative disclosures. Some banks even provided additional useful information like PD (probability of default) ranges and EL (expected loss) in percentages.

However,

- the presentation format differed from one bank to another, with some banks presenting the exposure classes in columns, others in lines, others using one table for each exposure class, while others presented one table by parameter (loss given default (LGD), risk weight (RW), credit conversion factor (CCF)); this different presentation of disclosures may even stem from the regulatory approach that does not prescribe a common format for the information required within Pillar 3;
- information on credit conversion factors was not provided in some cases; and
- the number of grades used to report information on parameters varied from 2 to 19 grades (not including default grade), which to some extent seems inconsistent with the 'meaningful differentiation' requirement set up in the CRD.

As far as the requirements on back-testing information are concerned, some banks chose not to disclose this information for reasons of confidentiality, while others did not provide information on back-testing without specifying the reason why.

- Only 35% of the banks provided quantitative information on back-testing and among those, only one bank provided information beyond three years.
- The approach taken to compare expected losses with actual losses differed widely between banks; while some banks used the expected losses as at the end of 2010, other banks retained the expected loss forecast as at the end of 2009, some assimilated actual losses to impairment charges (flow), while some considered balance sheet amounts (stock of provisions).
- Finally, data provided by the banks regarding actual and expected losses did not appear really comparable and indeed, various explanations were provided, showing the limits of any comparison between the two concepts.

The EBA identified the following best practice examples:

- clear presentation of the parameters by exposure classes including PD range (to allow for comparison), meaningful differentiation of credit risk, total amounts, comparative amounts (to highlight changes) (Barclays);
- emphasis placed on key points (to explain the main changes and other important facts) (RBS); and
- user-friendly presentation of the rating process by exposure class (Barclays, RZB).

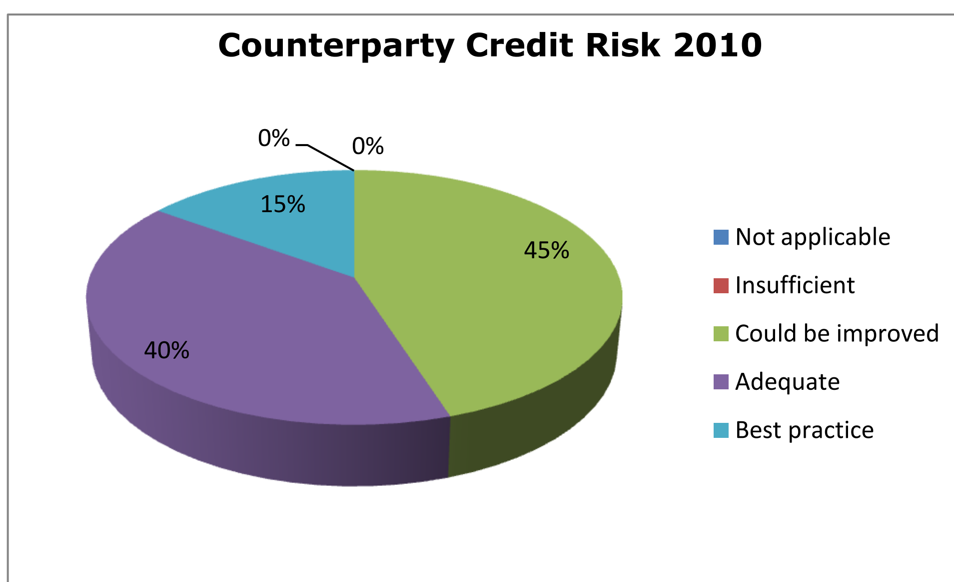
Interrelationship between IFRS and Pillar 3 disclosures

Many banks provided, in their annual report, a breakdown by rating for a number of portfolios (e.g. corporate, wholesale, institutions) and, in their Pillar 3 report, complete tables on the Basel II parameters (e.g. exposure-weighted average of RWA (risk-weighted assets), LGD, CCF). However, no bank made a link between the two types of information that could nevertheless be regarded as two different but still complementary ways of presenting information on the credit quality of performing loans.

As a whole, information on credit risk management and internal ratings was more developed in Pillar 3 disclosures, which notably expanded on internal rating systems. Yet in many cases, the information provided in the annual report added several pieces to a broader picture with, for instance, information on concentration risk, stress testing, or pricing.

It is further noted that in several cases, the Pillar 3 reports included general credit risk management disclosures that were identical to the disclosures in the annual reports.

4.2.2. *Counterparty credit risk*



Overall, we observed an improvement both in the quantitative and qualitative information provided by the banks included in the sample. However, for approximately 45% of those banks, disclosures on counterparty credit risk could be further developed.

For the banks that were assessed as not fully compliant, the main areas needing improvement are given below.

- Disclosures on notional value of credit derivative transactions and distribution of current credit exposure by type of credit exposure.
- A few banks seemed to focus only on derivatives, and omitted the counterparty credit risk relating to securities financing transactions (for example repos).
- There are also some cases where the impact of netting and collateralisation on the exposure was not provided.
- In terms of presentation, while many banks dedicated a specific part to counterparty credit risk, for some others, information on counterparty credit risk was mixed in with credit risk disclosures. This may generate some confusion, in particular with respect to credit risk mitigation techniques.

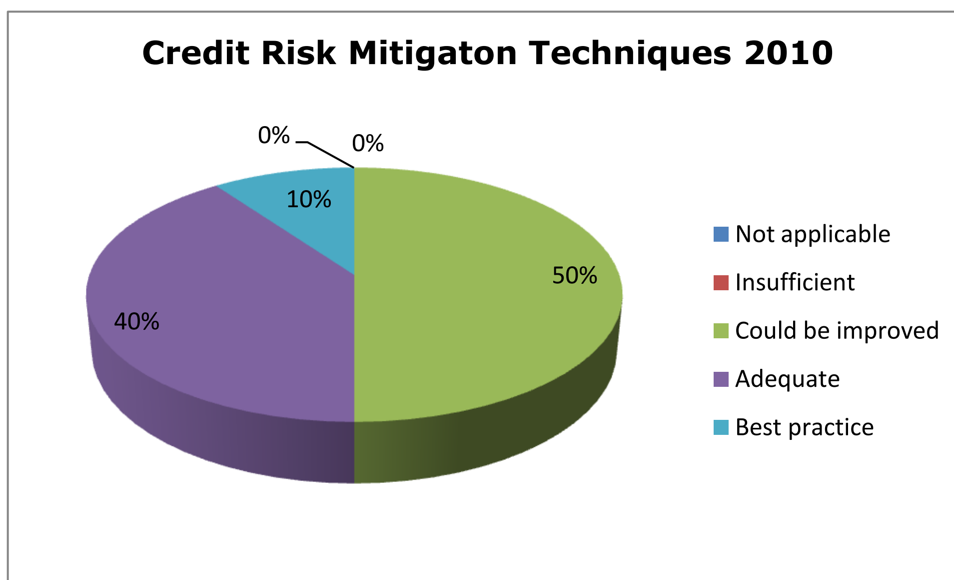
- Generally, the issue of wrong-way risk was not always addressed and when it was, this did not seem to be done using the same approach (e.g. a collateral policy perspective or a more general approach);

The most common best practices identified were:

- information on the risk-weighted exposure value (or capital requirement) for counterparty credit risk (as a subset of the information provided on credit risk) – (Société Générale, BNPP);
- development on credit value adjustment (so-called CVA) – (HSBC, Deutsche Bank, Barclays)

4.2.3. *Credit risk mitigation techniques*

Several banks made noticeable efforts to improve the disclosure of information on CRM techniques in 2010 compared with 2009. In particular, some banks provided quantitative information on exposures covered by eligible collateral and guarantees which had not been provided the previous year. As a result, the proportion of banks providing adequate disclosures or best practice disclosures rose from 20% in 2009 to 50% in 2010.



Despite this significant improvement, disclosures on credit risk mitigation could still be improved for half of the banks in the sample, particularly as regards qualitative information, which was often too brief and generic to be really useful.

- Most banks provided a generic list of collateral types without emphasising those that are used most frequently (if necessary by nature of activity).
- The same observation applies to protection providers and their creditworthiness.
- Disclosures on concentrations of credit risk mitigants were omitted in many Pillar 3 disclosures.
- In some cases, the qualitative information disclosed would have benefited from a reference to the activity to be mitigated (or type of mitigant used).

Regarding quantitative information, the level of detail and sometimes the content differed among banks.

- The scope of the disclosures differed; this is partly (but not exclusively) due to diversity in the prudential approaches taken.

- The number of exposure classes varied from bank to bank, although many followed the Basel II categories.
- In some cases, it was not clear whether credit derivatives were included in eligible guarantees and, as such, were disclosed in the tables.

The EBA identified some best practice examples:

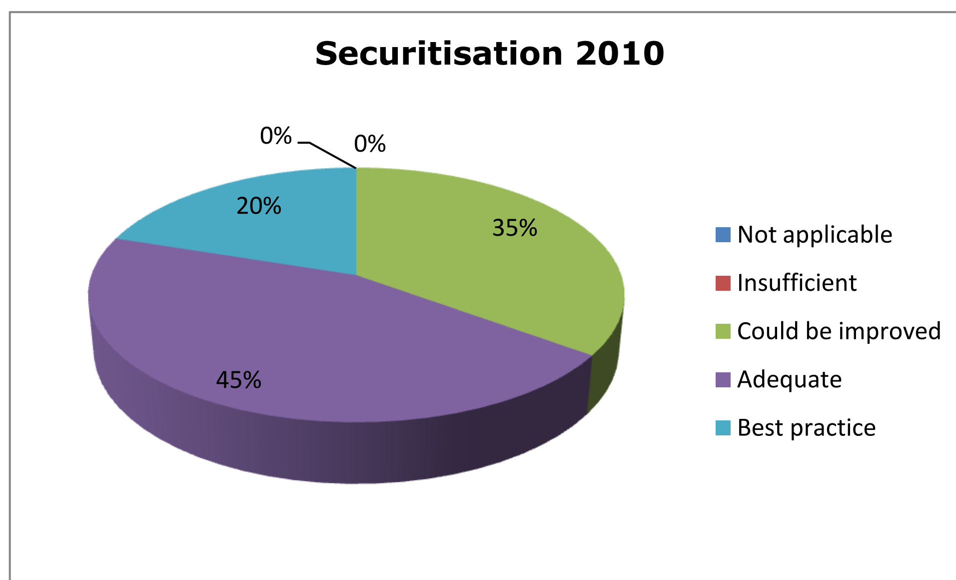
- clear disclosure of specific options adopted where regulations allow for several options, which is essential for the information to be well understood (Deutsche Bank);
- more disclosures broken down by type of mitigants – for example financial collateral, mortgage collateral, guarantees, credit derivatives, life insurance (Commerzbank);
- quantitative information on total exposures plus covered exposures, which can be used as a yardstick to assess the extent to which the different types of mitigation techniques are used (Deutsche Bank, Erste Bank, HSBC); and
- allocation of guarantors by rating (Intesa).

Interrelationship between IFRS and Pillar 3 disclosures

In general, little information on the measures taken to mitigate credit risk was provided in the annual reports. By contrast, the information provided in the Pillar 3 report or section appeared to be more detailed and complemented by quantitative information on the exposures covered by collateral or guarantees.

4.2.4. *Securitisation*

In general, disclosures on securitisation improved compared with the previous year, both in terms of clarity and detail.



The most noticeable improvements include the disclosure by many banks of a breakdown of securitised positions by exposure type. In some cases, the descriptions provided were also more informative compared with the previous year and more consistent with industry good practice guidelines.

Despite the overall general improvement in the quality of disclosures, there were several areas where there is room for improvement.

- Banks often provided generic disclosures regarding accounting policies for securitisation activities setting out the general derecognition and consolidation

rules, but without explaining how they interrelated with prudential rules and without explaining how the general accounting rules impacted the bank's specific activities (e.g. which activities are derecognised or deconsolidated). In the latter cases, credit institutions sometimes only made a vague reference to SIC 12 consolidation – special purpose entities (SPEs) - without providing more details.

- The aggregated amount of securitisation positions by exposure type was not always provided.
- There was varying granularity in the breakdown of risk-weight bands. Indeed, we noted a variation from four bands to nine bands, creating a comparability issue.
- Information on impaired exposures and losses recognised during the year was sometimes missing.
- Partial information on the securitisation activities in the period.
- Presentation was uneven of securitisation exposures by type of exposure (some banks did provide a breakdown by funds while mentioning the type of assets held by the fund).
- There was varying granularity of the disclosures which was linked to the approaches used for calculating risk-weighted exposures.

With regard to the absence of disclosures, it should be noted that it was difficult to assess whether that was due to the nature of the information (e.g. being immaterial, confidential, simply not applicable), or whether there was deficient disclosure practice. Examples include general information on securitisation activity, impaired or past due securitised exposures or revolving exposures.

However, the assessment revealed some best practice disclosures including:

- information on the management of securitisation risks (Dexia, BNPP);
- comprehensive breakdown by exposure type, geographical area and maturity, for securitisations carried out on behalf of clients (Sociéte Générale, Unicredit, Deutsche Bank, DZ Bank);
- definition of concepts (Rabobank, Crédit Agricole, RBS, Dexia);
- comments on the evolution of the exposures (Dexia, RBS, HSBC, Barclays, Sociéte Générale) and/or on impaired exposures (Deutsche Bank, Sociéte Générale);
- amount of assets transferred but not derecognised (Unicredit, Commerzbank, Santander, BBVA , BNPP); and
- information on banks' securitisation exposures in the trading book (Unicredit, Intesa, ING) and breakdown of retained exposures by accounting portfolio (Intesa).

The last two best practices listed above concern disclosure of information that may be helpful in the reconciliation between accounting and prudential data.

Interrelationship between IFRS and Pillar 3 disclosures

As a whole, accounting and prudential requirements may be regarded as complementary to each other, though there are significant differences. Pillar 3 requirements are wide-ranging, but do not include information on trading book securitisations which are included in the FSB (Financial Stability Board) recommendations'. Other key differences are: (i) the way consolidation of SPEs is done on the prudential and the accounting basis; (ii) the different focus of the information, meaning that the FSB recommendations focused on the exposures to the subprime crisis which is not the case for prudential exposures and (iii) the fact that

exposure values can be different (gross off-balance sheet exposures for IFRS versus EAD for Pillar 3).

In practice, the EBA did not observe any real attempts by the banks included in the sample to benefit from the complementary nature of the requirements. Indeed, a few banks emphasised the dissimilarities between the two sets of information due to the points mentioned above.

Regarding other topics, very few cross-references were found to bridge annual and Pillar 3 reports. Most cross-references from Pillar 3 report to annual report concerned accounting policies (e.g. consolidation principles under SIC 12 and/or derecognition principles under IAS 39).

Securitised assets and retained interests (originator's perspective)

In accordance with the IFRS 7 requirement on derecognition, banks must provide, where applicable, information on the securitised assets retained on the balance sheet.

In some cases, this information was similar to that provided in the Pillar 3 report or section because the bank had apparently taken an accounting view. In one case, the prudential information had been used to comply with accounting requirements. However, in many cases, the choice made by the bank and the implications thereof were not clearly stated.

Indeed, securitised assets under the prudential securitisation framework are considered regardless of any accounting derecognition treatment and therefore they do not coincide with securitised assets retained on the balance sheet from an accounting perspective. This is all the more the case since prudential securitised exposures include synthetic securitisations which are not disclosed under the accounting standards.

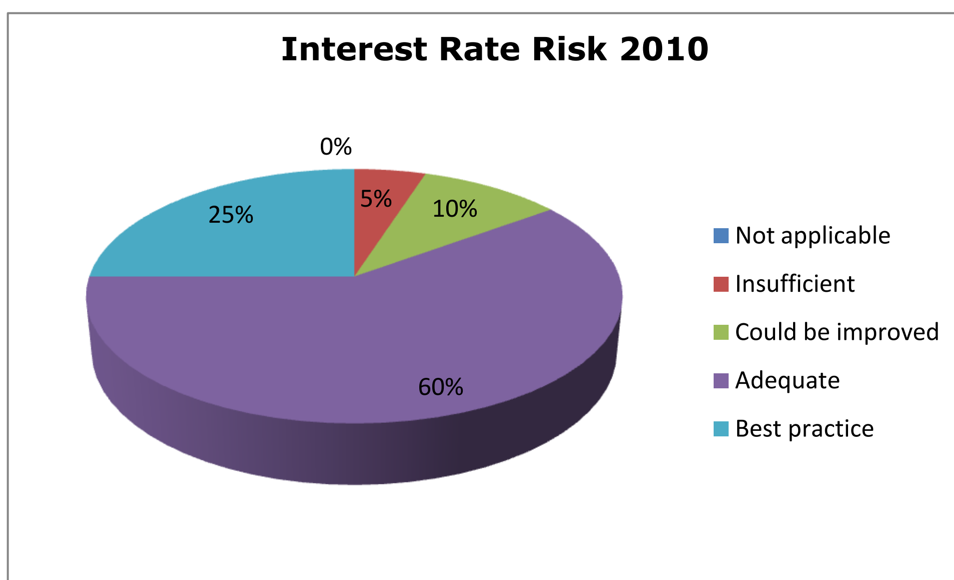
The information on accounting treatments required under the CRD, as it stands, did not appear sufficient to highlight the interrelationship between accounting and prudential securitisation information. Further clarification supplemented by elements of reconciliation should help to fill the gap.

Securitisation positions purchased (sponsor and investor perspective)

In addition to securitisation positions linked to securitised assets, banks should provide information regarding their purchased securitisation positions as a sponsor and/or investor. While not identical, this information overlaps to a large extent with FSB specific information (more particularly, when banks have re-classified most of their subprime exposures outside their trading book). Establishing a link between the two set of disclosures would be helpful to users.

In practice, very few banks mentioned why the figures were different (i.e. differences of scope, information on banking book exposures only for Pillar 3, etc.) and no reconciliation was made, even though, in a few cases, information on subprime crisis exposures were provided in the Pillar 3 report.

4.3. Interest rate risk



The majority of the banks - 85% of those in the sample - complied with CRD requirements. Again, the basic requirement regarding interest rate risk – the sensitivity analysis – could be presented in a more informative way with further details of the assumptions used. The results of the sensitivity analyses also appear to be non-comparable because:

- banks did not use the same aggregate to measure the interest rate risk (annual earnings at risk, interest margin, economic value of equity, economic capital), nor the same measurement tools (daily value at risk, BPV, VaR, interest rate gap);
- some assumptions that are relevant for an understanding of the quantitative disclosures were not always provided (balance sheet assumed to be constant or not over time, management actions to reduce risk taken into account or not, time horizon of the sensitivity analysis, etc.);
- banks used different scenarios for modelling the risk, Many banks considered parallel shift of the yield curve but with a varying range (i.e. 50 bp, 100 bp, 200 bp, etc.), some banks considered only the impact of upward rate shocks; one bank did not disclose the direction of the shock. Only few banks provided more than one sensitivity scenario; and
- sensitivity analyses used different measures (e.g. value or percentage figures).

The EBA also observed that:

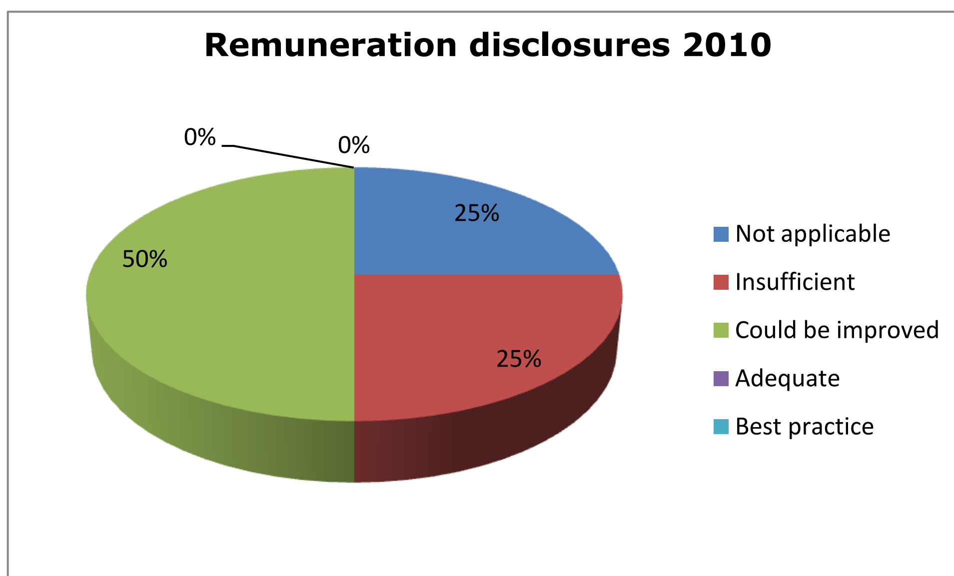
- many banks stated that the purpose of their risk management is to protect their interest margin and yet, they only provided sensitivity analysis on the economic value;
- in most cases, reporting frequency was disclosed instead of frequency of measurement of interest rate risk; and
- in some cases, no currency breakdown was provided.

The EBA identified the following best practice disclosures:

- meaningful description of key assumptions (BBVA, Rabobank);
- good description of strategy and governance (Erste Bank, Crédit Agricole, Société Génerale, BNPP);

- disclosure of existing limits and monitoring process and frequency (Barclays, BNP, Rabobank, RBS, Unicredit); quantitative figure on limits (Dexia, Société Générale);
- clear discussion of the main drivers of interest rate risk (Banco Santander, BBVA, BNPP, Deutsche Bank, HSBC, Société Génerale, UBS);
- disclosure of sensitivity analysis for both earnings and economic value (ING, Rabobank);
- information on the instruments used to hedge the interest rate risk (HSBC, UBS, RZB); and
- specific focus on the interest rate risk for a given geographic area or activity (Santander, Dexia).

4.4. New Pillar 3 requirements – remuneration



Assessment of remuneration disclosure requirements led to the conclusion that there was room for significant improvements. Indeed, for 75% of the banks of the sample, disclosures on remuneration were generally insufficient or could be improved. However, it should be noted that these are new requirements. Therefore it is not surprising that better disclosures could be achieved. In particular, we noticed that improvements were needed on the following areas:

- aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the credit institution; and
- breakdown of quantitative information by business area.

In addition, the information was not comparable, both in terms of presentation and regarding the categories of staff retained.

Despite the need for improvements, most banks provided useful information about the decision-making process for remuneration and related policies, and gave helpful descriptions of their remuneration system's main characteristics. In addition, banks often provided details of the different remuneration components for senior management (including individual directors where relevant).

The EBA identified the following best practices:

- detailed description of the risk implications of the remuneration process; and

- publication of remuneration disclosures in the Pillar 3 report (or separately but clearly cross-referenced to the report) so users can understand how remuneration is linked to an institution's risk strategy. Some banks disclose such prudential information elsewhere for different reasons, such as national requirements, and this is believed to impair that understanding.

5. Annex I - *List of banks covered in the sample*

Erste Bank

RZB

Dexia

UBS

Commerzbank

Deutsche Bank

DZ Bank

Banco Bilbao Vizcaya Argentaria, S.A. (BBVA)

Santander

BNP Paribas

Crédit Agricole SA

Société Générale S.A.

Intesa Sanpaolo

UniCredit Group

Banque et Caisse d'Epargne de l'Etat (BCEE)

ING

Rabobank International

Barclays

HSBC

The Royal Bank of Scotland (RBS)

6. Annex II -*Checklist of Pillar 3 disclosures*

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
CHAPTER 5 **DISCLOSURE BY CREDIT INSTITUTIONS** *Article 145* 1. For the purposes of this Directive, credit institutions shall publicly disclose the information laid down in Annex XII, Part 2, subject to the provisions laid down in Article 146.					
2. Recognition by the competent authorities under Chapter 2, Section 3, Subsections 2 and 3 and Article 105 of the instruments and methodologies referred to in Annex XII, Part 3 shall be subject to the public disclosure by credit institutions of the information laid down therein.					
3. Credit institutions shall adopt a formal policy to comply with the disclosure requirements laid down in paragraphs 1 and 2, and have		Good practice to disclose a separate policy for Pillar 3 disclosures,			

[6] These good practices are provided for illustration. They are also intended to facilitate identification of other good practices.

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
policies for assessing the appropriateness of their disclosures, including their verification and frequency.		highlighting the appropriateness of the disclosures, mode of verification and frequency of disclosure.			
[Article 146] Not directly relevant					
Article 147 1. Institutions shall publish their disclosures as soon as practicable 2. Credit institutions shall determine whether more frequent information is required.		CEBS considers that active financial institutions should publish certain quantitative information more frequently.	Are Pillar 3 disclosures published simultaneously with financial assessments? If not, how much time elapses between the publications? How many times per year must Pillar 3 disclosures be published? Have supervisors imposed deadlines?		
Article 148 1. […] What medium, location and means of verification have been chosen? Have all disclosures been provided in one medium or location? [The analysis should indicate where (e.g. annual report or separate publication) the institution chose to provide the disclosure, its location and whether it has been verified or even audited.]			Specify if Pillar 3 report is an independent document or a separate section in the annual report. Indicate whether the Pillar 3 report is accessible on the web. Indicate if the information has been verified or audited internally or externally. Is audit or verification of the		

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
			Pillar 3 information required at national level? Is the information checked by national authorities before it is published?		
2. Equivalent disclosures made by credit institutions under accounting, listing or other requirements may be deemed to constitute compliance with Article 145. *Have credit institutions indicated where disclosures can be found if they are not included in the financial statements?*					
Article 149 Notwithstanding Articles 146 to 148, Member States shall empower the competent authorities to require credit institutions: (a) to make one or more of the disclosures referred to in Annex XII, Parts 2 and 3; (b) to publish one or more disclosures more frequently than annually, and to set deadlines for publication; (c) to use specific media and					

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
locations for disclosures other than the financial statements; and (d) to use specific means of verification for the disclosures not covered by statutory audit. Have there been disclosures about any such requirements?					
Annex XII - Technical criteria on disclosure **Part 1 – General criteria** 1. […] Materiality. 2. […] Proprietary information. 3. […] Confidential information. 4. […] Need for more frequent disclosures 5. The disclosure requirement in Part 2, points 3 and 4 shall be provided pursuant to Article 72 (1) and (2). Is there an indication as to whether disclosure has or has not been provided more frequently on these grounds? Are there explanations about the criteria used?		In the previous report, the fact that some banks had provided the threshold for materiality was identified as good practice.			

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
Part 2 - General requirements 1. The risk management objectives and policies of the credit institution shall be disclosed for each separate category of risk, including the risks referred to under points 1 to 14. […], (a) to (d)					
Part 2 – General requirements - Scope of consolidation 2. Information regarding the scope of application of the requirements of the Directive […] (a) to (e)		Some banks provided reconciliations between Pillar 3 and annual accounts			
Part 2 - General requirements - Own funds 3. Information regarding own funds […] (a) to (e)		i) Reconciliation of IFRS equity to Tier 1 capital; and ii) in addition to capital resources and the capital ratio, an explicit disclosure of the additional capital requirement due to the Basel I floor (provided by several banks).			
Part 2 – General requirements – Counterparty Credit Risk 5. Information regarding the credit		i) quantitative information on potential future credit exposures for			

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
institution's exposure to counterparty credit risk as defined in Annex III, Part 1 […] (a) to (i)		derivatives; ii) breakdown of EAD by exposure classes and by internal ratings; iii) concentration measure of counterparty risk; and iv) breakdown of counterparty credit risk exposures by contract type.			
Part 2 – General requirements – Credit and dilution risk 6. The following information shall be disclosed regarding the credit institution's exposures to credit risk and dilution risk [...] (a) to (i)					
Part 2 – General requirements – Interest Rate Risk 13. Information about the exposure to interest rate risk on positions not included in the trading book […] (a) and (b)		i) presentation of interest rate gap by maturity; ii) a table setting out the minimum, maximum, average and end-of-the-year value for the interest rate VaR; iii) principle of using			

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
		several scenarios, including a steepening or a flattening of the yield curve; iv) mention of the quantitative limit used internally for the management of the interest rate risk; and v) clear discussion on the main drivers of interest rate risk.			
Part 2 – General requirements - Securitisation 14. The credit institutions calculating risk weighted exposure amounts in accordance with Articles 94 to 101 shall disclose the following information about securitisation activities […] (a) to (l)		Some banks have been very specific with their strategy, while others provided comments on the changes between periods.			

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
Part 2 – General requirements – Remuneration *(new point)* Recital (21) of CRD III: Good governance structures, transparency and disclosure are essential for sound remuneration policies. In order to ensure... 15.The following information, including regular, at least annual, updates, shall be disclosed to the public regarding the remuneration policy and practices of the credit institution for those categories of staff whose professional activities have material impact on its risk profile (a) to (h)		N/A			
Part 3 - Qualifying requirements for the use of particular instruments or methodologies 1. Disclosure about internal rating systems […] (a) to (i): 2. Disclosure about credit risk mitigation techniques […] (a) to (g)		i)analysis of expected credit model performance versus actual results over a particularly long period, or at the parameter level; ii) probabilities of default (bucket or mean) for each internal grade; and iii) discussion on the			

CRD DISCLOSURE REQUIREMENTS	Score	CEBS observed good practice disclosures (from 2010 assessment template with some simplifications)[6]	Summary description of disclosures (w/ references) and related observations/Assessment	Comparison with annual report where relevant information is listed	Comparison to the previous assessment [with reference to the (Y-1) score]
		approach retained for its ratings with regard to the situation in the economic cycle i)a table presenting the exposure amounts, the part secured by guarantees and credit derivatives and the part secured by collateral type of regulatory approach; ii) clear explanation on the Basel II treatment of the various types of CRM; and iii) amount of guarantees and collateral held against impaired loans.			