16 January 2008

Summary of the Workshop on the Implementation of Pillar 3

On 7 December 2007, CEBS' Expert Group on Financial Information (EGFI) organised a workshop with the participation of the industry and its stakeholders on issues surrounding the implementation of Pillar 3 – Market discipline.

The main aim of the workshop was the discussion of the findings of a survey CEBS had carried out on approaches followed by countries for the implementation of the provisions included in chapter 5 of Directive 2006/48/EC on the disclosure to the market by credit institutions and investments firms. In addition, the workshop provided an opportunity to receive further input from industry and market participants regarding any problems they have with respect to Pillar 3 disclosures.

Morning session

Mr. Vossen welcomed the participants to the workshop and provided an overview of the agenda. The workshop's audience was comprised of national supervisory authorities, representatives of banks, trade associations, rating agencies and of the European Central Bank (ECB).

CEBS presentation on issues found in the survey on the regulatory implementation of Pillar 3 Arnoud Vossen (EGFI Chairman, DNB)

Mr. Vossen started his presentation with an overview of the Pillar 3-related efforts conducted by CEBS during 2007 (i.e. a survey exercise and the preparation of a related report on the implementation of Pillar 3 disclosures in EEA countries, regular exchanges of information between supervisory authorities, a meeting with representatives of the European Banking Federation (EBF) and finally the organisation of the present workshop on Pillar 3 implementation issues).

The report covers all relevant aspects on the regulatory implementation of Pillar 3 in each jurisdiction. It nevertheless focuses its attention on a number of aspects, which were – following on the basis of internal and external exchanges - considered to be the most relevant or problematic. The report regroups the issues as follows:

1. Application of the disclosure requirements to significant subsidiaries: The outcome of the stock-take shows that most countries only require the limited disclosure from significant subsidiaries; however there are some differences across CEBS members regarding the determination of what is a significant subsidiary. Mr. Vossen explained that the fact that some supervisors require (limited or full) Pillar 3 disclosures from all (significant) subsidiaries reflects the perceived relevance of these subsidiaries for the local market or stems from current disclosure practices in these markets. As a way forward, CEBS proposes to

investigate the possibility of a solution where limited extra Pillar 3 disclosures are being provided, together with the individual financial statements of the subsidiaries in question.

2. Disclosure policy and general concepts: the report also discusses different aspects regarding the approaches taken by national authorities to the disclosure policy. An overview is given concerning possible requirements for publication or supervisory approval of the disclosure policy, or with respect to the prescriptiveness regarding the content. It also covers supervisory approaches regarding the concepts of materiality or confidentiality. Mr. Vossen concluded that the findings did not give rise to any major concerns.

3. Other issues: Mr. Vossen explained that the report also investigates supervisory approaches with regard to the frequency of Pillar 3 disclosures, the means and location of these disclosures and the verification question of Pillar 3 data. Although the industry raised some concerns, especially on the issues of verification, Mr. Vossen noted that the findings of the survey showed that only very few countries depart from the provisions foreseen in the CRD.

As a follow-up to the report's findings, Mr. Vossen noted that CEBS decided to strive for a practical solution regarding the application of the disclosure requirements to (significant) subsidiaries and would be willing to take part in a debate on the relationship between Pillar 3 and accounting disclosures, in as far as the EU banking industry would feel that this would be needed.

Participants generally commended CEBS for the timeliness of the study and of the workshop and expressed as a preliminary view that the conclusions of the report and the proposed follow-up were agreeable. They also welcomed that CEBS intends to carry out this follow-up in cooperation with the industry and stakeholders.

One participant noted that there is no assurance that comparable disclosures will become available to Pillar 3 data users, as e.g. no common reporting formats are available. CEBS representatives noted however that banks' inappropriate behaviour will be disciplined by external stakeholders.

One participant questioned the timing of the first disclosures of Pillar 3 information and enquired on the possibility to include some guidance on this aspect in the report.

Participants also enquired whether the report could identify which country is following which approach as this information is deemed to be very helpful for the application of Pillar 3 by a cross-border operating firm. CEBS representatives noted that they will aim to accommodate this suggestion.

One representative put forward some concerns regarding the usefulness of some of the specific disclosure items as required by the Directive and suggested that supervisors could review these items. Mr. Vossen mentioned that the usefulness of Pillar 3 data is determined by its users and for this it would be a topic to be discussed primarily between the banking industry and its external stakeholders. Furthermore it would also be difficult for CEBS to re-open this debate since both the Basel Committee and the European Commission have rejected revising Pillar 3 at this point in time. A way forward would now be to first gain experience with Pillar 3 disclosures, and discuss the outcomes. He nevertheless suggested to take this issue on board for discussion during the afternoon session of the workshop with the aim to find ways to overcome the concerns, since both participants from the banking industry and some their external stakeholders were present.

Perspective of a Cross-border group

Jonathan Gray (Royal Bank of Scotland)

Mr. Gray provided an overview of the issues that a large banks faces with regard to thePillar 3 implementation and the challenges it poses. As one of the main issues, he emphasised the potential for confusion among market participants and the need for education to improve their understanding of the new capital framework.

From a practical perspective, the most challenging issues seem to relate to the differences in timing and frequency of the disclosures, to the differences in the scope of information and to the reconciliation that is needed to explain the data to external stakeholders. Mr. Gray also underlined that the implementation of Pillar 3 is not to be under-estimated in terms of resources and system changes.

Mr. Gray also addressed the relationship between Pillar 3 disclosures and IFRS. He explained the differences between the two frameworks (e.g. equity treatment, definitions of past due, of provisions and impairment) and the efforts of the British banking industry to try to align as much as possible the concepts used in the disclosures in order to improve the comparability of the information between different institutions.

Mr. Gray finished his presentation by emphasising the need for industry cooperation and the challenge of improving the knowledge of market participants. In this context, he felt that there should be a communication strategy involving supervisors. This should focus on different aspects before, during and after the application of Pillar 3 (e.g. improving the education of key audience groups before the 'launch', reviewing the disclosures to adapt them to the needs of external stakeholders after the 'launch').

Some participants echoed the importance of the communication strategy and confirmed that there may be a role for supervisors.

Perspective of a rating agency

Bernard de Longevialle (Standard & Poor's)

Nick Hill (Standard & Poor's)

The presentation focused in its first part on the reasoning for a different capital measure by S&P. While stating that the new capital framework and the disclosure regime introduced by Pillar 3 was welcomed, Mr. Hill also explained that differences in the national implementations of Basel II bear the risk that the comparability among institutions would not be sufficient for rating agencies to provide consistent assessments.

Mr. de Longevialle explained in the second part the approach that S&P is considering for the coming years. He clarified that S&P will follow two different approaches: a base case approach based on the public or available information and a specific case approach which takes into consideration entity-specific data.

Additionally, he elucidated that in order to achieve data comparability, S&P intends to adjust certain Basel II parameters (e.g. by setting floors for certain exposure classes or adjustments for diversification or concentration). It was noted that S&P plans to build internal databases populated with Pillar 3 information.

The S&P representative also put forward a number of suggestions for additional disclosures, such as a breakdown by standardised exposure classes; information on geographic or sector breakdown.

Finally, Mr. de Longevialle stressed that the new approach does not imply a change in the assessments, but a more comprehensive methodology completed with other relevant information. He also pointed out that the assessment can be modified on a case by case as a result of the dialogue with individual institutions.

In the ensuing discussion workshop participants put forward a number of questions on the S&P approach. In that context a few participants expressed concerns on some of the aspects of the methodology such as the introduction of floors or the use of an alternative capital measure.

Participants from the banking industry also observed that they would be worried were S&P to intend publishing their capital measure, given that in their view the co-existence of such a ratio next to the regulatory ratios would be likely to create confusion in the market.

Afternoon session

From the feedback received during the morning session, the chairman chose three topics to be dealt with by the participants in the break-out sessions:

1. disclosures of significant subsidiaries,
2. content of the current Pillar 3 disclosures (including disclosures in the current market situation), and
3. education of market participants and the risk of misinterpretation of Pillar 3 information.

The outcome of the discussions in the break-out sessions can be summarised as follows:

1. Disclosures of significant subsidiaries

In general workshop participants consider that significant subsidiaries should only make disclosures when they are useful for the external stakeholders. However, it was acknowledged that there might be diverging views in this respect. Should a significant subsidiary be defined from the point of view of the parent company or based upon its significance for the local market? In this respect most participants felt that the stakeholders are generally focused on the parent. It was also considered that many of the market participants are not making resources available to analyze Pillar 3 information on subsidiary level.

Additionally, there was a feeling that the disclosures at subsidiary level could be misleading given that the subsidiary may be subject to a different methodology for the calculation of capital requirements than the parent (i.e. the subsidiary applies the standardised approach, whereas the parent uses internal methodologies), Finally, participants emphasised that requiring the full Pillar 3 information implies going against the provisions of the CRD.

As a way forward, participants perceived that a potential solution could be to disclose the information at the level of the parent, while allowing local stakeholders an easy access to the information of the subsidiary (e.g. by publishing the information in English). In this context, it was felt that the parent could disclose additional information on significant subsidiaries that would be useful for local stakeholders, especially if the subsidiary has issued equity or debt instruments listed in a local financial market. It was not felt that this information should necessarily be located in the financial statements.

Furthermore, participants discussed the application of the waiver foreseen in article 72.3 of the CRD to subsidiaries of non-EU parents. It was considered that the main issue relates to reciprocity of treatment for subsidiaries of EU parent institutions. It was also noted that certain jurisdictions outside the EU require full disclosure of Pillar 3 information for the subsidiaries located in these countries.

2. Content of the current Pillar 3 disclosures

Secondly, participants analysed the content of the current Pillar 3 disclosures. A contribution from one national banking association, which presented a number of concerns related to specific disclosure requirements included in the CRD, served as the basis for this discussion. In general workshop participants had mixed feelings. It was felt that there was little room to modify the content of the Pillar 3 disclosures. Rather banks should discuss their concerns with external stakeholders before asking for changes in the regulation. Participants felt also that a possible solution could be to use a balanced level of detail in presenting the data as requested by the CRD and that more explanations on the concepts that banks used for the disclosures would be helpful in the first stages of the implementation.

Related to this issue, participants also discussed the relationship between Pillar 3 and accounting disclosures. In general, it was felt that no major problems should arise, although participants recognised the difference in the scope of consolidation and in valuation (carrying amount vs. exposure value in the advanced methodologies). As a possible solution, it was proposed to provide additional explanations on the differences in order to clarify the context of the data. Participants acknowledged that disclosures made in the context of the financial statement are equivalent to the disclosures required by the CRD.

Finally, participants discussed Pillar 3 disclosures against the background of the current market situation. Generally, it was felt that Pillar 3 was not designed for stress situations, although participants perceived that transparency could be a valuable tool to improve the confidence of market participants in the current situation.

3. Education of market participants and the risk of misinterpretation of Pillar 3 information

Participants also discussed possible ways to improve the knowledge of market participants about the capital framework. In this context, it was deemed useful to classify market participants in different categories, depending on whether they are professional experts or not, and on whether they are information-users or opinion-formers.

There was agreement that different strategies are needed for the different categories: these could include workshops and conferences for institutional investors and newsletters for the press. The communication strategy should be focused on building confidence in the new capital framework, on explaining the different approaches used therein and on investigating as much as possible the alignment of bank practices and of the concepts they use.

Moreover, the group discussed the possibility of developing a joint communication strategy by the industry and supervisors. While supervisors felt that the primary responsibility in this initiative is for the industry, they recognised that they could also play a role in facilitating the process. It was concluded that events such as the present workshop are very helpful.

Finally, participants considered the differences between the transition to Basel II and the transition to IFRS. In this context, banking representatives considered that there were different cases, due to the complexity of the new capital framework and the lead of the accounting profession in the process of transition to IAS/IFRS.

Conclusion

Both the morning and afternoon session were felt as being very helpful in the implementation of Pillar 3 within the European Union. It was agreed that the topics that were touched upon during the workshop could be further taken on board in this and other settings with participation of the industry, Pillar 3 users and supervisory authorities; not least given that for 2008 a further shift towards Pillar 3 as one important area of work in the context of Basel II and CRD-implementation is foreseen.