Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System

Training Program ~ 8 – 12 December 2008
SHANGHAI, CHINA

Session 8.1

Bank's Perceptions of Pillar 3 and its Operation

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The Basel II Framework includes within its structure of Pillars an explicit focus on "market discipline" through market disclosure – known as Pillar 3.

> *Pillar 3 compliments the minimum capital requirements of Pillar 1 and the supervisory review processes of Pillar 2. Its aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on a firm's capital, risk exposures and risk assessment processes. The disclosures are to be made to the market for the benefit of the market.*
>
> FSA "Practical Information for Firms on Pillar 3"

The initial focus of Pillar 3 has been the provision of quantitative information of the risk types covered by the regulatory requirements of Pillar 1 plus descriptions of associated risk management and governance practices. This is supported by the Accord's in principle statement that "banks' disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank" [paragraph 810.].

By encouraging market discipline the regulatory requirements for Pillar 3 are intended to assist in building and maintaining market confidence in individual institutions and the banking system more generally. Clearly a key assumption here is that the information disclosed by banks is viewed by market participants as sufficient in light of economic circumstances and is disclosed in a manner that is understood by market participants.

The Australian bank experience with Pillar 3 has been that significant market education has and is required about the Basel II Accord. This includes the drivers of its various risk components and capital adequacy outcomes as well as explanations of the structure of the Basel II Accord and the intended role of Pillar 3.

There appears to have been an initial over-emphasis by market participants on a single metric, the overall capital adequacy ratio, reflecting a widespread expectation of potential capital relief following implementation of the new Accord. This is despite the Australian regulator making clear that such relief, if any, would be modest and spread across several years. That this relief has not occurred and the fact that Australian banks have lifted their tier 1 capital ratios during 2008 has no doubt contributed to a willingness to participate in this Pillar 3 education.

Australian banks have also considered it necessary to explain that different regulatory requirements across national jurisdictions can result is significantly different capital adequacy ratio outcomes – particularly the reported tier 1 capital ratio. Recently the Australian Bankers' Association (ABA) released a comparison of UK and Australian regulatory requirements that showed for some Australian banks there could be a difference in excess of 200 bps for reported tier 1 capital ratios.

The ABA noted that "different regulatory frameworks in Australia and other jurisdictions can make it difficult for investors and analysts to make like-for-like comparisons between Australian banks and banks operating offshore".

These types of differences if left unexplained would have the potential to cause uncertainty and inappropriately impact market confidence about Australian banks, at a time of general market difficulty, and in so doing undermine the rationale of Pillar 3.

The current period of financial turmoil has also highlighted that Pillar 3 disclosures are mainly limited to Pillar 1 risk issues and credit risk in particular. This means that Pillar 3 does not seek to measure / explain the financial condition and performance of financial firms which is primarily the role of accounting standards.

The Financial Stability Forum Report released in April 2008 noted that “weaknesses in public disclosures by financial institutions have damaged market confidence during the turmoil”. The Report’s recommendation of enhanced disclosures, particularly with respect to securitisation exposures and off-balance sheet vehicles and activities, has occurred with Australian banks making these disclosures as part of their financial accounts reporting and not Pillar 3 disclosures.

It is a recommendation of the Financial Stability Forum that the Basel Committee release further guidance to strengthen disclosure requirements under Pillar 3 to cover many of these issues by end-2009.

It is too early to say whether at this time these points are acting to undermine the overall effectiveness of Pillar 3 and market acceptance of its being a tool of transparency and discipline as initially intended. The Financial Stability Forum report refers to the need to ensure that disclosures made are “most relevant to the market conditions at the time of disclosure”. The Report’s recommendation number III.2 makes clear that such decisions about the evolution and flexibility of Pillar 3 should involve investors, financial industry representatives and auditors and not only be left to the regulators to determine. Such a process of itself will further contribute to Pillar 3 being an educative tool that effectively contributes to market discipline and confidence.

MAFC / APEC / AFDC Shanghai Conference: Session 8.1: Basel II Pillar 3 Disclosures

8 – 12 December 2008
Bruce Le Bransky

Key points to be covered

- Why Pillar 3 – Market Discipline
- Key Principles of APS 330 – APRA's Pillar 3
- Need for Market Education
- Pillar 3: Some issues and gaps
- What NAB did for Pillar 3 – substantial preparation
- What NAB did for Pillar 3 – certification and assurance
- Certification and Assurance (cont.) – APS 310
- Appendix A: APRA's Pillar 3 Disclosure Tables

Why Pillar 3 - Market Discipline

- **Objective of Disclosure**: Provide Transparency and Enhance Confidence in Banks and Financial Markets.

  Pillar 3 is part of the Basel II Framework.
  Separate to disclosure disciplines of the Accounting Standards / Corporations Code.

- **How Achieved**: By setting <u>minimum</u> requirements of Pillar 1 disclosure:

  Risk management practices / capital adequacy / credit risk.

- **Consequence**: Substantial increase in "new" qualitative and quantitative risk information.

Key Principles of APS 330 – APRA's Pillar 3

Key Principles of Disclosure:
Timely and of high quality
Consistent with how Boards/ Management assess and manage risk
Consistent with complexity of business and risk management

Governance Principles:
Formal Disclosure Policy including as to content and control "process"
Process: appropriateness/accuracy/validation of disclosures

General Requirements:
Disclosure at a Group level of information.
Published on website within 40 business days
Host regulator requirements exist.

Verification Requirements:
CEO must attest to reliability.
External audit is not specifically required.

Need For Market Education

- **Problems:**

  Consistency in definitions (transparency): Establish ABA working group to help clarify definitions for information to be provided to the market.

  Information is new /unfamiliar (confidence). Interpretations/analysis open to error and so could negatively impact market confidence.

- **Solution: General Market Education – Australian Bankers Association:**

  ABA briefing session with analysts and investors on Pillar 3 disclosures. APRA attended and provided a presentation on Pillar 3 and its role.

  - Inform those who will analyse / report / comment about detail of the disclosures.
  - Highlight those disclosures where a range of interpretations are possible and where the requirements on Australian banks differs from those offshore, consequences of these differences.
  - Outline differences amongst Australian banks.
    Eg partial implementation of the IRB approach within a Group.
  - Panel of key executives from participating banks and APRA: answer questions and provide industry-wide view of issues.

Pillar 3 – Some Issues and Gaps

- Impact of Current Market Conditions:
  - Market uncertainty about banks' risk profiles and sensitivity to changing market conditions.
  - FSF is recommending greater engagement with market participants to ensure relevance of disclosures.
- Pillar 3 is a significant starting point but not a final outcome:
  - For internationally active banks the Financial Stability Forum considered Pillar 3 disclosures insufficient. Recommended additional disclosures for off-balance sheet transactions & SPVs.
  - NAB provided an addendum to its latest Annual Report to address the FSF recommendation.
- Who are the intended readers of the Pillar 3 reports?

  Market discipline requires capability to make comparisons across institutions – ie a high level of financial literacy about Basel II and risk management practices.

Pillar 3 – Some Issues and Gaps (cont)

- Australian banks' capital ratios and home-host differences.
  To provide transparency about regulatory "comparability" the ABA and individual banks have been providing information on the differences with and capital adequacy outcomes under FSA rules.
  [APRA requirements result in Tier 1 capital ratios being approx 200 bps lower than would be reported under FSA rules.]

- How will regulators seek to use Pillar 3 information in their published financial stability reviews?

- What are the potential revisions to Pillar 3 arising from the recommendations of the Financial Stability Forum that the Basel Committee issue further guidance in 2009 to strengthen Pillar 3.

What NAB Did for Pillar 3 – Substantial Preparation

- Internal working groups established to address APS 330 obligations:
  - Changes to *Group Disclosure and External Communication Policy*
  - Participate in ABA Pillar 3 industry forum
  - Internal "dry-runs" conducted before final report prepared. Connects to the ABA working group issues.
  - PBRC review pro forma Pillar 3 disclosure report.

- A new "Risk and Capital Report" created for Pillar 3. Is now NAB's primary risk disclosure report:
  Accompanied by significant investor pack.
  Australian Financial Report (AFR) now limited to providing results information in accord accounting standards / corporations law requirements.

- The assurance processes used for AFR expanded to cover the new APRA prudential (Basel II) returns and the APS 330 disclosures.

- APS 330 Disclosure on the ASX Notices website the same day as publication on NAB Group website.

What NAB did for Pillar 3 - Certification and Assurance

Expansion of the Annual Certification Framework for sign-off of the AFR to cover Pillar 3 and APRA Basel II prudential report forms.

Management Certification and Sign-off	**Input data, risk engines and calculations and internal control framework.**	**Preparation of risk and regulatory capital information presented in the *Basel II Reporting Management Summary* and reported in the *Profit Announcement.***	**Capital adequacy and risk disclosure in APRA reporting, *Annual Financial Report* and *Risk & Capital Report* (APS330).**	**CEO Attestation APS 310**
	Signed off by Regions and Group Risk Functions	Signed off by Regional CEOs, Group Risk and Capital Mgt GMs, GCRO	Signed off by Regional CEOs, Group Risk and Capital Mgt GMs, GCRO	
Internal Audit/ Financial Governance	**Review certain procedures and controls.** (scope based on annual work plan)			
External Audit	**Assurance**			

Certification and Assurance (cont.) – APS 310

- CEO declaration (endorsed by the Board):
  - Identification of key risks has occurred
  - Systems are in place to monitor and manage those risks and operating effectively including the establishment of adequate and timely reporting.
  - Risk management descriptions provided to APRA are accurate and current
- Role of External Auditors

  External auditors are to provide APRA with an opinion as to whether:
  - The ADI has observed all the prudential standard requirements which an APRA has set for the ADI
  - The statistical and financial data provided by the ADI to APRA are reliable.
  - The ADI has complied with statutory banking requirements

Key points covered

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Appendix A: APRA's Pillar 3 Disclosure Tables

Specific information must be disclosed in tables, containing quantitative and/or qualitative information. These requirements are documented in APRA's APS 330.

Attachment A: Extensive market disclosure

Quantitative information: released bi-annually

Qualitative information: released annually

1. Scope of Application
2. Capital:
   - Capital Structure
   - Capital Adequacy
3. Risk Exposure and Assessment:
   - Credit Risk
     - General Disclosures
     - Portfolios subject to Standardised App.
     - Portfolios subject to IRB Approach
     - Credit Risk Mitigation
     - Counterparty Credit Risk
     - Securitisation
   - Market Risk
     - Standardised Approach
     - Internal Models Approach
   - Operational Risk
   - Equities (Banking Book position)
   - Interest Rate in the Banking Book

Attachment B: Basic market disclosure

Quantitative information: released off-quarters

1. Scope of application
2. Capital:
   - Capital Structure
   - Capital Adequacy
3. Credit Risk Exposure:
   - Credit Risk – General Disclosures