2 nd Islamic Financial Services Forum: The European Challenge
Session 6: The IFSB Standards – A Direct Comparison to Basel II

Transparency and Market Discipline

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Transparency and Market Discipline (I)

Papers of the Basel Committee on Banking Supervision (BCBS)

- „Core Principles for effective banking supervision“ (BCBS September 2007 updated October 2006)

  “In order for market forces to work effectively, (…)market participants need access to correct and timely information. Disclosure, therefore, is a complement to supervision.”

- „Enhancing Bank Transparency“ (Transparency Group of the BCBS September 1998)

Several recent studies on measurement of market discipline:

- Federal Reserve Bank of NY: Economic Policy Review September 2004);
- Bank of England: Financial Stability Review December 2004;
- ECB: monthly Bulletin February 2005

Transparency and Market Discipline (II)

Study by the Federal Reserve Bank of New York (Economic Policy Review September 2004):

- Aim: Give empirical evidence on whether disclosure is beneficial for banks and helpful for financial markets
- Relying on an database of 600 banks in 31 countries over the years 1993 - 2000
- Analyzing the relationship between volatility of a bank's stock price and the amount of information the bank discloses to the market
- Construction of disclosure index based on annual accounts
- Conclusion:
  - Enhanced disclosure reduces stock market volatility
  - Results in lower refinancing costs for well-managed banks
  - If volatility is a measure of investor uncertainty, reduced volatility means reduced uncertainty on financial markets

Transparency and Market Discipline (III)

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Study by the Bank of England (Financial Stability Review December 2004):

- Major concern: enhanced transparency might destabilize financial markets
- Distinction between ex ante effects and ex post effects;
  - Ex ante: transparency increases the sensitivity of the bank's funding terms to the risks it takes → bank should be interested in developing cautious business practices
  - Ex post: if a bank is hit by an adverse shock disclosed information could run the bank into even more difficulties ("bad" effect); information contagion on other banks could be limited ("good effect")
- Annual data on 550 listed banks from 32 countries over the years 1994 - 2000
- Measure of transparency based on information on its risk profile in its annual account
- Analysis of the link between transparency and the likelihood of a bank crisis
- Conclusion:
  - Banks that disclose more information are less likely to experience a crisis;
  - Pillar 3 disclosures could improve overall financial stability
  - If a trade-off between "good" and "bad effects" on financial stability exists, the benefits of transparency outweigh its costs

Transparency and Market Discipline (IV)

Study by the ECB (Monthly Bulletin February 2005):

- Deals with conceptual issues concerning market discipline and describes to what extent market discipline could complement banking supervision.
- Puts Pillar III in the broader context of direct and indirect market discipline
- Conclusion:
  - For direct market discipline market participants in general lack incentives and possibilities to impose market discipline on banks.
  - Indirect market discipline at present may only work for large institutions.
  - It could be helpful for banking supervision to incorporate market indicators into their early warning models.
- Preconditions to improve:
  - Market participants need sufficient information about banks (Pillar III).
  - Deposit insurance should be limited to small depositors; other creditors must be credibly left out of the "safety net".

Transparency and Market Discipline (V)

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Study by Deutsche Bundesbank (Monthly Report October 2005)

- **Distinction between direct and indirect market discipline:**
  - Direct: reactions of market participant on disclosed information impose pressure on the entity itself;
  - Indirect: reactions of market participant influence decisions of third parties (rating agencies, supervisors).

- **Distinction between market participants**

  (equity holders, depositors, other banks)

- **Distinction between market indicators, that can trigger market discipline**

  (Share prices, interest rates in the inter-bank market)

Transparency and Market Discipline (VI)

Potential market participants facilitating market discipline

Market participant	Opportunity of influence	Incentives	Weight of market participant	Relevance of MD
Shareholders	Shareholders‘ meetings (direct MD), behavior	Less sensitive to high risk taking (as return tends to increase)	High	+
Subordinated debt holders	Price of debt instrument	Fully exposed to a bank‘s risk	High	+
Other banks	Large amounts traded at inter-bank market	Fully exposed to a bank‘s risk	High	+
Depositors	Behavior	Exposed to a bank‘s risk (but dep. Insurance)	Limited	-

Transparency and Market Discipline (VII)

Assumption: Improved level of transparency result in market indicators reflecting banks‘ riskiness more accurately

Which market indicators are suitable?

Market participant	Market indicator
Shareholders	Stock prices
Subordinated debt holders	Spreads of subordinated debt instruments
Other banks	Spreads of interbank deposits
All market participants	Credit Default Swaps
All market participants	KMV-EDF (Rating)

Pillar 3 Material elements

- Disclosure requirements with Pillar 1 methods as a basis
- Corresponding developments in accounting
- Confidential information protected
- Material information only
- Scope: Disclosure only on top consolidated level
- Semi-annual frequency
- Appropriate medium and location
- Risk management verification: back testing
- Enforcement

Pillar 3 The disclosure requirements

- **Scope of application**
- **Capital structure**
- **Capital adequacy**
- **Risk exposure and assessment**
  - Credit risk
  - Market risk
  - Operational risk
  - Interest rate risk in banking book (IRRBB)
  - Equities: disclosures for banking book positions

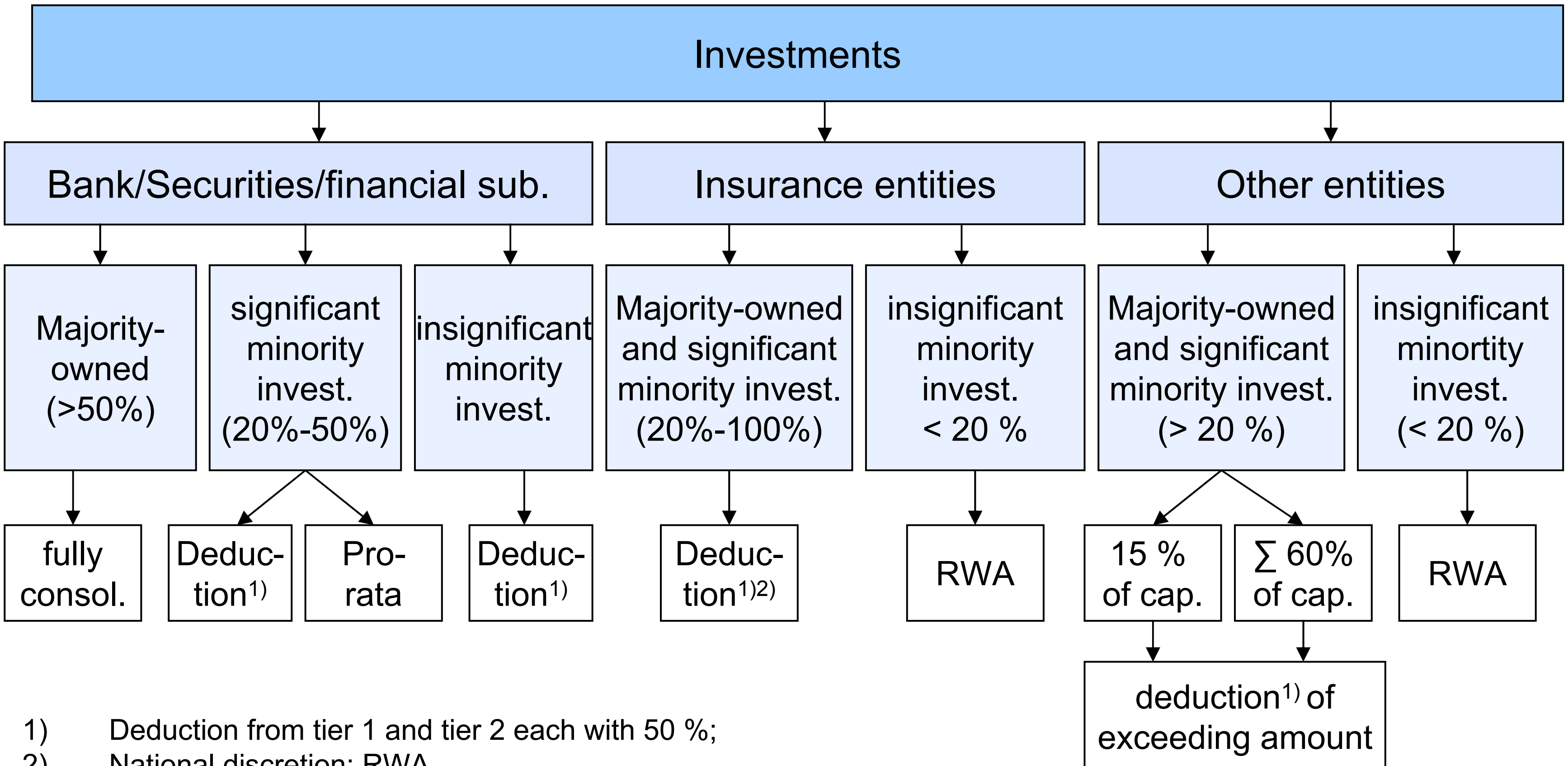
Pillar 3 Scope of application

- **Basel II to be applied on a consolidated basis as well as at lower levels to all internationally active banks**

- **Banking groups: different definitions between accounting and banking supervision**
  - → explain banking group defined for supervisory purposes and its entities
  - → explain treatment of entities for consolidation (full, pro-rata, deduction, risk-weight, recognition of surplus capital)

- **Explanation of any restriction on transfer of funds**

Pillar 3 Scope of application



1) Deduction from tier 1 and tier 2 each with 50 %;
2) National discretion: RWA

Pillar 3 Capital structure

Qualitativ

Terms and conditions of capital instruments (esp.innovative, complex or hybrid)

Quantitativ

Tier I

- paid-up share capital
- Reserves
- Minority interests
- Innovative capital
- Other capital instruments
- Surplus capital from insurance companies

Tier II + III (total amount)

Capital deductions Tier I, II +III

(incl. Deductions when expected losses as calculated in IRB approach exceed total provisions)

Total eligible capital

Pillar 3 Capital adequacy (a)

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- **Bank's approach on adequacy of capital**
  (economic capital)

- **Total and tier 1 capital ratio**
  (consolidated and for significant subsidiaries)

- **Capital requirements**
  (breakdown by type of risk and by type of supervisory method used)

Pillar 3 Capital adequacy (b)

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Capital requirements

Credit risk
- (Simplified) standardised approach
- IRB approaches
- Securitisation

Equity exposures in IRB
- Market based approaches
- PD/LGD approaches

Market risk
- Standardised approach
- IMA

Operational risk
- Basic indicator approach
- Standardised approach
- AMA

Pillar 3 Risk exposure and assessment: survey

Risk exposure and assessment				
Credit risk	Equities in banking book	Market risk	Operational risk	Interest rate risk in banking book
qualitative	qualitative	qualitative	qualitative	qualitative
quantitative	quantitative	quantitative		quantitative

Pillar 3 Risk exposure – qualitative

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General qualitative requirements
(Risk management objectives, structure and policies)

Supplementary qualitative requirements for specific risk types

Credit risk

- Definitions used
- Descriptions of IRB for 5 portfolios
- Types of collateral
- Potential Concentration
- Securitisation

Market risk

- Description of internal model
- How internal model is verified

Op. Risk

- Methods the bank is qualified for
- Use of insurance (AMA)

Interest rate risk in the banking book

- Assumptions regarding early prepayment
- Behaviour of non-maturity deposits

Equities in the banking book

- Motivation
- Treatment in accounting

Pillar 3 Risk exposure – quantitative (a)

Quantitative requirements

Credit risk

• Exposure (different breakdowns; provisions; reconciliation of allowances; exposure by risk weight – stand. app.; PD-grade – IRB)

• Verification

• Recognition of collateral / risk mitigation

• Securitisation

Market risk

• Standardised approach (capital requirements for sub categories)

• Internal models (VAR; back-testing results; analysis of important outliers

Interest rate risk in the banking book

• Sensitivity analysis

(impact on earnings or capital)

Equities in the banking book

• Current book values and fair values

• Realised and unrealised gains and losses and impact on capital

Pillar 3 Risk exposure – quantitative (b)

1. Credit risk

- **Exposure**
  - by category, geographical distribution, sector distribution, maturity
  - with specific provisions and past due by geographical and sector distribution
  - reconciliation of allowances
  - standardised approach: exposure by risk weight; IRB: exposure by PD-grade (advanced: with exposure weighted average LGD and EAD)
- **Verification**
  - for each portfolio comparison of actual losses in the preceding period with past loss experience
  - comparison between expected losses and actual losses for periods beginning 2009; could be extended to PD-,LGD-, and EAD analysis
- **Recognition of collateral / risk mitigation**
- **Securitisation**
  - securitised exposures by type, impaired and past due exposures, realised losses, broken down by risk weights
  - securitisation exposure with details (exposure type, risk weight bands)

Pillar 3 Risk exposure – quantitative (c)

2. Market risk

- standardised: capital requirement for further sub categories
- internal models: high, average and low VAR over the reporting period and VAR at the reporting end; back testing results; analysis of important outliers

3. Operational risk

→ Explanation of method used (qualitative only)

4. Interest rate risk in banking book

→ Sensitivity analysis (impact on earnings or capital)

5. Equities: disclosures for banking book positions

- Disclosure of current book values and fair values
- Realised and unrealised gains and losses and impact on capital