

# W is dead, but no closure on disclosure

**At the end of September the Basle Committee on Banking Supervision signalled key concessions on its proposed reform of bank regulation and capital charges. Rob Jameson reports on industry reaction to the climbdowns**

**T**he wheels within wheels that represent the Basle II reform process for bank capital adequacy ground on a little further in late September with concessions<sup>1</sup> from the regulators on the treatment of credit mitigants, and the publication of two key discussion papers on operational risk<sup>2</sup> and the public disclosure<sup>3</sup> of bank risks.

Early industry reaction to the new regulatory thinking is mixed. There's much happiness at the regulator's main concession on credit mitigation: the demise of the 'w' factor. This factor would have reduced, from a capital charge perspective, the effectiveness of credit derivatives and collateral as mechanisms of risk transfer.

There's also relief about the reduction in proposed capital charges for operational risk from 20 per cent to 12 per cent of minimum regulatory capital, and a guarded welcome for the reduced number of disclosure requirements.

On operational risk, practitioners cheered as the regulators stepped away from their original ambition to prescribe a limited range of creaky quantification methodologies, and moved towards an 'open door' policy that will encourage industry to experiment with a diverse range of internal models in this still-developing field.

Duncan Martin, ERisk consultant and credit risk expert, says the shifts

by the regulators this autumn represent concessions – after some strong criticisms by industry – on the 'fudge factors' built into the January 16 proposals.

Early tests suggested that the capital charge under the January 16 proposals would be even higher than charges under the existing regime. The fudge factors were originally built into the proposals to calm the nerves of more conservative regulators as they agreed for the first time to let banks use inter-

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nal risk-sensitive methodologies for calculating the size of regulatory capital charges for credit.

But the banking industry remains concerned that the 'w' factor might re-emerge under the guise of supervisory concerns – Pillar 2 of the regulatory framework – in some jurisdictions where local regulators were keen on the concept, such as the UK. Under Pillar 2, local regulators can increase bank capital charges for specific institutions if they are worried about a risk man-

agement issue. And while the regulators have loosened up their attitude to banks building their own operational risk measurement models, it's clear from the appendix to the operational risk paper that both the industry and the regulators have a shaky statistical platform on which to build even the most basic quantification methodologies. In particular, the much-heralded 'beta' factor that was to tailor the capital charge to variations in the risk profile of different banking business lines is looking hard to pin down.

The biggest industry worry, though, is that the disclosure requirements have not been pruned back enough, with signs that the regulators are beginning to dig their heels in on further concessions. The new paper says that the “current disclosures are considered essential and support the Pillar 3 objective of facilitating market discipline [and] should be considered requirements”.

Industry associations say they also remain worried about the timetable. With the papers on operational risk and disclosure still looking like work in progress, they point out that there remains a queue of papers to be published, and issues to be worked through, this autumn. These issues include specialised lending (project finance), securitisation, retail risk, best practice in operational risk

management, and – perhaps most important – the analysis of the results from the regulators' quantitative impact study.

Still, there are many upbeat moments in the early industry reaction to the end-September papers and announcements. The Institute of International Finance issued a note welcoming the demise of the 'w' factor, though it remains worried that it might re-emerge in another form. It's hoping that the Pillar 2 approach will be implemented in a manner "that does

not exacerbate uneven playing fields and can [instead] serve as a penalty for failure to meet industry standards for collateral management".

The IIF is also likely to welcome some aspects of the operational risk paper when its working groups meet over the next few weeks. Interviewed by ERisk in the first week of October, Barbara Matthews of the IIF says that the institute's working groups, while supportive of the effort to make the calculation framework as

objective as possible, urged the Basle Committee in the spring not to select one methodology over another. The end-September paper now indicates that any number of methodologies could qualify, she says.

The paper on disclosure raises other questions, says Matthews. The IIF made a series of proposals on disclosure to the Basle Committee in the spring, but Matthews says these differ from the proposals put forward in the end-September paper. She says it's the

## No closure on disclosure

**PUBLIC DISCLOSURE BY** banks of key risk statistics is one of big ideas in the regulators' proposed new capital and regulatory regime. So it's something they're loath to water down too much in the face of industry criticism that the new requirements will prove expensive, damage competitive advantage, overlap with new accounting requirements and be under-used by the markets.

But it's clear that, in their end-September paper, the regulators have made some effort to clarify some issues and amend others in response to industry worries. The new disclosure paper says that the purpose of the semi-annual disclosures is to allow market participants "to reach a view on the risk profile of the organisation". The information required can be determined using a "materiality" concept – would a reasonable investor think the item to be material? It needn't be externally audited. And the regulators reckon that for many smaller or less complex institutions, disclosures "will not be necessary simply because they do not engage in particular activities to any significant extent".

How the information is published is likely to be up to the national regulator, but the paper says that simple website publication is one possibility – providing all information is published in one place "to the degree feasible".

The degree and complexity of disclosure will depend to an extent on the methodology a bank selects for calculating its credit and operational charges. But with most banks now seemingly heading for the internal ratings based methodology, this is unlikely to defuse concern in the industry.

The disclosure rules for such banks will mean that once a year they'll have to describe qualitatively their credit rating and management system. At least twice a year – possibly more often for internationally active banks with fast-changing risk profiles – they'll have to disclose Tier 1 and total capital adequacy ratios and their components. More radically, they'll also have to publish an analysis of the current credit portfolio in terms of their exposures to six probability of default grades plus default. This will be high-level combined data, so it won't be possible to see where a bank went wrong in terms of an individual default. But as time goes on, the verification information a bank will have to publish will make it possible for outside observers to check whether, at a general portfolio level, the realised default level is equivalent to that predicted by the bank's rating system.

Similar public verification will apply to other key risk factors – loss given default, exposure at default and statistics such as the total loss on retail loans as a percentage of average drawn exposures over the year. Meanwhile, the degree to which credit risk is mitigated will be made public through disclosure of totals for on-balance sheet netting, collateral and credit guarantees/derivatives.

The disclosure requirements on asset securitisation are intended to force a bank to own up to high-risk retention of valuable but credit risky assets. This is a significant worry for regulators at present, since such 'credit enhancement' of securitisations was behind a number of bank failures in the US in the past five years. The proposed rules on disclosure state that

banks will have to publish the: "Aggregate amount of credit exposure retained arising from credit enhancement provided to the transactions, (including I/O strips, cash collateral accounts, liquidity facilities and other subordinated assets), by asset type (eg credit cards, home equity, auto, etc) plus a declaration that support is limited to these contractual obligations."

This all should mean that the market will be able to see more clearly what a bank thinks its risk profile looks like and, crucially, how good the bank has been at predicting that profile in the past. Whether this information will be as useful, and used, as the regulators intend is another issue. ERisk's journalists tend to find that even specialist bank analysts rarely track published market value-at-risk figures for investment and other banks. Instead, they say they take comfort from the fact that a bank possesses such a system, and seem to rely heavily on general perceptions of management and control quality.

If this behaviour continues into the credit arena, it might be that analysts simply look at the capital charge methodology a bank is allowed to use by the regulator, and never get as far as the detailed data and its verification. An argument against this, however, is the attention paid by analysts to credit deterioration and to unexpected announcements of additional reserving by banks. The new disclosure requirements might offer specialist analysts information that puts them one step ahead in this information game – especially as credit risk is a slower moving, more fundamental risk for most banks than is market risk, and will probably be more usefully trackable under Basle's proposed new regime. ■

definition of the 'portfolios' to which the Basle proposed disclosures apply that is likely to be the key to analysing the impact of the proposals.

Experts say that banks are concerned about making public lots of detail on their credit portfolios for a number of reasons. The most dramatic is the concern over proprietary information and confidentiality. To give an extreme example, a hedge fund or other market partic-

side core company reporting. Others say the problem of co-ordinating the disclosures with accounting requirements has not been resolved.

Ironically, it's the standardisation and bringing together of data that lies at the heart of the problem that regulators themselves face in developing an operational risk capital charge.

Carratu says that while the regulators, and the industry, would love

they admit they might anyway spend in the general push to improve systems and shift to an economic capital framework.

Other commentators point out that, with it taking much longer than expected to work out a framework for operational risk, the result is likely to be a much vaguer framework in the final document. The flexibility this implies will be welcomed by banks, but it also means a much less welcome degree of interpretation by local regulators – and therefore a less transparent, less level, regulatory environment.

Richard Metcalfe of the International Swaps and Derivatives Association says that ISDA welcomes the drop in the proposed capital charge for operational risk, but continues to be worried about the quantification methodology.

At this stage, he's hoping that whatever form the final proposals take, "due consideration is given to the impact on individual firms – don't forget that the proposals are likely to be translated into the EU directive, where they will catch firms in the investment industry as well as banks".

He says that even if the regulators find a defensible way of setting the industry-wide beta factors, these could have very different implications for specific institutions and their unique mix of business lines. ■

## ‘A hedge fund that knew the exact extent of a bank’s exposure might be well placed to trade around that exposure at a time of crisis’

ipants that knew the exact extent of a bank's geographic credit exposure – say, to an emerging market country with a significant dependency on mineral wealth – might be well placed to trade around that bank's implied credit exposures at a time of crisis.

But Domenic Carratu of Adsatis, a London-based financial services data management consultant, says it's the problem of amassing and then publishing complicated and important information to a mass audience that's causing most of the angst. "If risk management information is wrong when it's reported to a senior executive, or even a regulator, it's embarrassing but it can be corrected. But you can't offer apologies and erratum slips to the world's markets," he says. As a result, some banks are worried they will have to treat the publication as an elaborate corporate communications issue along-

to have a rigorous and defensible approach to quantifying operational risk, it's clear the project is battling against the paucity of existing data on operational losses, sampling problems, and data inconsistency.

He points out that in a survey<sup>4</sup> he conducted late this summer, some banks said they continued to see few real business benefits from spending money on operational risk data gathering and modelling. This is in contrast to the money they will have to spend revamping their credit risk management systems in line with the new internal ratings based approaches, which is cash

### Web sources and references

- 1 [http://www.bis.org/publ/bcbs\\_n12.htm](http://www.bis.org/publ/bcbs_n12.htm)
- 2 [http://www.bis.org/publ/bcbs\\_wp8.htm](http://www.bis.org/publ/bcbs_wp8.htm)
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