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The Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs,

WORKING PAPER ON PILLAR 3 - MARKET DISCIPLINE

ISDA continues to support the objectives of the Committee and agrees in principle that the new capital regime should be supported by enhanced public disclosures on capital, risk exposure, management and the capital adequacy of an institution.

ISDA appreciates the tone of the working paper and notes that comments made by the banking industry in the previous consultation period have generally been taken into account.

However, we continue to have a number of concerns with the current proposals. Our comments below should be viewed in conjunction with our comments in May 2001 relative to the January Consultative Paper.

GENERAL COMMENTS

The vehicle for disclosure

We appreciate the increased flexibility allowed by the Committee for disclosures to be made through means other than the financial statements, which addresses a number of the concerns that we raised in our May 2001 comments.

We would recommend that further guidance be given as to which forms of regulatory reports will be acceptable media for these disclosures and how "public regulatory reports" are defined across jurisdictions. This is important as we would see many of the disclosures to be much better placed in a regulatory filing rather than in the financial statements. However, the risk should be avoided that banks have to meet a wide range of different disclosure requirements both for regulatory purposes as well as for financial reporting. Accordingly, we would recommend that it is made clear that the regulatory disclosures should be based on financial accounting information.

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The volume and complexity of the disclosures and the usefulness of financial statements to professional and “reasonable” users

Although we note that in a number of areas there has been a significant reduction in the volume of disclosure, the requirements are still extensive. Indeed they still go significantly beyond what the Fisher and Shipley groups recommended as sensible, evolutionary enhanced public disclosure.

In some areas there remains too much specificity in the qualitative disclosure requirements which will be difficult, if not impossible, for readers of corporate reports to digest. By way of example we would draw attention to the following requirement – “for each portfolio with subdivision as necessary...describe the methods and data for estimation and validation of PD, LGD and EAD, including assumptions employed in the derivation of these variables.”

We are still concerned that the investor education which should precede the release of this information is not addressed. As many of the disclosures involve reasonably complex calculations, guidance on the methodology underpinning Basel II and on how results should be interpreted is essential to ensure that reporting institutions are not penalised for disclosing activities that may appear risky to the untrained eye. In aggregate, the disclosures could possibly lead to inappropriate market reactions with negative economic impact on institutions.

Level of detail in portfolio breakdowns

There is much focus in the working paper on providing detail on a portfolio level. However, this level of detail often conflicts with the need to maintain confidential information, and also provides too great a level of detail to be clearly understood by a reader – which can again lead to a risk of misinterpretation. We have set out some specific concerns on individual paragraphs below.

Generally we would recommend that the Committee be more descriptive than prescriptive. For example, rather than require banks to disclose risk weighted assets before and after credit risk mitigation, the Committee should place more emphasis on disclosure of how banks use credit risk mitigation techniques and how this impacts their risk profile. This then gives banks the ability to use their discretion to make disclosures that are consistent with their view of the appropriate supporting detail.

Level playing field between regulators

A key purpose of Pillar 3 would appear to be the enforcement of the capital regime on a consistent basis by national supervisors. Accordingly we believe it would be useful if some disclosures were to be made by the supervisors themselves. These could focus on the number and types of approvals given to firms – for instance authorisation to use advanced IRB for credit, or an advanced measurement approach for operational risk. Such disclosures would be useful tools to enable both the industry and the public to assess how the Accord is being applied by individual supervisors. However, it is accepted that any such disclosures should only include high level aggregated statistical information.

SECTION 1**Paragraph 10 - Interaction with accounting disclosures**

We commend the recognition of the need for consistency with accounting requirements. However, we would raise a timing issue in respect of IAS 30. Under our current understanding of the respective timetables, the final Basel proposals are expected to be issued by February 2002 whereas the exposure draft of IAS30 is not expected until June – hence a continuous coordination with the IAS30 Advisory Group is more important than just reviewing the Pillar 3 proposals “in light of” the exposure draft. Coordination with the accounting standard setters should include both content and timetables.

Paragraph 14 - Scope

We would recommend that further guidance be given on the circumstances that national supervisors will consider when assessing whether disclosures should be made at a sub-consolidated level. If left solely to national supervisor discretion, this increases the risk of creating inconsistencies between different national jurisdictions.

Clarification should furthermore be given on how the term “top consolidated level” should be interpreted. Presumably this relates to the top consolidated level that falls within the Basel regime, rather than the top consolidated level of the group. Based on our presumption, we would agree that disclosure of information at the top consolidated level is sufficient, and there should not be a requirement to disclose at the level of legal entities at a sub-consolidated level. Disclosure at the top consolidated level only should ensure international comparability.

SECTION 2**Paragraph 16 – Overarching Principles**

We would recommend that the word “summarised” be added to the requirement to disclose risk management objectives and policies. This would fit in with the allowance for materiality set out in Paragraph 11, and would remove the question as to the level of detail required.

Requiring banks to disclose “their risk management objectives and policies ...” will be extensive and could lead to unnecessary details. These policies, for the most part, are wide ranging and contain proprietary information. Additionally, although there may be standard overall corporate goals and policies, the specific details of the policies may differ between business units and operating locations. These specificities may change frequently and will result in an ongoing effort to make sure that the disclosed detail remains relevant.

Paragraph 18 – Scope of Application

We do not understand why a full list of all potential impediments on the transfer of funds or regulatory capital within the group would be meaningful for the reader. Such restrictions are often subject to interpretation of rules and could be altered during crises anyway.

With regard to the disclosure requirements for financial groups combining banking and insurance activities, ISDA is concerned that the disclosure of the impact of different methods (surplus capital, consolidation, deduction approach) of treating insurance subsidiaries results is an additional burden. Such groups should exclusively be required to disclose the effective treatment of insurance subsidiaries and be exempted from comparing the impact of this treatment with other possible treatments. National regulators should be given the flexibility to decide which approach – e.g. surplus capital, consolidation, deduction, or risk weighting of investment is most appropriate for the specific group.

Capital Adequacy***Paragraph 21 - Capital strategy***

We would recommend that further guidance be given on what level of detail is required to be disclosed in respect of “capital strategy”. A detailed description of a bank’s capital strategy would normally be viewed as confidential information. However, a summary qualitative statement of a bank’s capital strategy should not be problematic as banks already present this to analysts and rating agencies.

Paragraph 21 - Quantitative disclosures

The level of disclosure proposed will enable the recalculation of the target ratios applied in those countries where the ratio applied is above the minimum 8%. This can potentially lead to pressure on regulators to conform to the minimum. This does not fit within the purpose of Pillar 3 disclosures which are meant to ensure that banks and regulators are applying the Capital Accord correctly, rather than assess which national regulators require capital in excess of the 8% threshold. This is also inconsistent with the current approach by national regulators who are generally reluctant to publish ratios themselves.

We would further welcome confirmation that only the capital requirements resulting from the chosen approach (eg advanced internal ratings approach for credit risk and not all possible approaches (eg standardised and foundation IRB) have to be reported.

Credit Risk***Paragraph 24 - General disclosures for all banks***

Under the quantitative disclosures set out in relation to past due/impaired loans, there is the risk that there could be circumstances a particular debtor may be identified from the information disclosed. Hence, we would recommend that there be an exemption from the disclosure requirement if this is the case.

In addition, we do not see the relevance of the amount of credit risk transferred in an evaluation of the risk of the bank. It is the remaining risk of such transactions that is relevant for market transparency.

Paragraph 26 - Disclosures for banks on the IRB approaches

We generally believe that these disclosures go too far and are concerned that banks will be required to disclose information that should be treated as proprietary. This would appear to be inconsistent with the recognition in paragraph 12 of the need for proprietary information not to be disclosed.

The detail of a bank’s IRB and risk management approaches has often taken years of investment to develop. Disclosing it in detail would potentially compromise a bank’s competitive position.

We are particularly concerned by the disclosure of details surrounding the estimation of PD, LGD and EAD. The requirement to disclose “for each portfolio, with subdivision as necessary” is likely to result in very extensive and complicated disclosures. The calculations required are often complex and will not be easily explained to a reader. The expected detail on LGD is especially concerning.

The quantitative disclosures are equally excessive. The level of specificity will not benefit the reader and will result in significant resources having to be assigned to developing these disclosures. We also see here the danger of misleading / misinterpreted information with possible unjustified negative market reactions.

A reasonable investor need to know no more than that the relevant supervisor has tested and approved the models used. A general summary of the approach adopted could accompany the regulator’s statement.

Equities in the banking book

Paragraph 27 – disclosures for banking book positions at all banks

The differentiation between holdings on which capital gains are expected and those taken under other objectives may be an area of difficulty. There is no definite distinction between holdings for strategic or capital gains reasons, as both aims do not mutually exclude each other.

Only aggregated information should be required, as opposed to both book and fair value of individual investments. This is particularly true for sales where confidentiality about the price is agreed in the contract.

Credit risk mitigation techniques

Paragraph 28

We would recommend that instead of requiring details on credit risk mitigation techniques, more emphasis is placed on how banks use credit risk mitigation techniques and how this impacts their risk profile.

Asset securitisation

Paragraph 29

It is not clear why 30 days is selected for performance data on securitised assets. This seems inconsistent with the definition of default elsewhere in the Accord, and may give rise to a risk of misinterpretation.

Market Risk

Paragraph 31 - Disclosures for banks using the standardised approach

We do not agree that the capital charge for options positions should be a required disclosure. Options should be viewed in the context of general market risk factors, and not isolated as a separate product.

Interest rate risk in the banking book

Paragraph 34

The quantitative disclosures proposed will, in our opinion, provide sufficient information to enable a competitor to predict the risk position of the bank and use this information to take arbitrage positions against the bank. Accordingly we oppose to the disclosure of this information.

CONCLUSION

In summary we believe that the potential level of detail and complexity of the disclosures proposed in the working paper is still excessive, particularly in the credit section, and will be beneficial neither to external readers nor to the banks disclosing them. Instead we suggest that more coordination (both in terms of content and timetable) be achieved with the international accounting standards setters, and that any information required to be presented in a more summary fashion.

ISDA hopes that consideration will be given to the comments in this letter and we are keen to cooperate. Should you have any further questions, do not hesitate to contact us.

Yours faithfully,

ISDA