THE ASSESSMENT OF SLOVAK BANKS´ PILLAR 3 DISCLOSURE

Michal Medo - Paulina Stachová[18]

Abstract

The purpose of this paper is to theoretically describe the current regulatory environment with a focus on Pillar 3 of Basel standards, its principles, guidelines and perspective of better comparability and transparency, what would enhance the overall reliability of banking sector. Research of the paper concentrate on the in-depth review of Slovak banks´ Pillar 3 reports and compares their extent and quality with the best practices in chosen fields of disclosure (Own funds, Credit risk, Market risk, Remuneration), and sets the recommendations for improvement.

1. Introduction

Key issue of the banking regulation is to determine right level of the capital inevitable to cover banking risks related to their business activities. The specificity of banking industry is that their capital base for business activities conduction consists of very minor part of its own funds. Thus every bank is being exposed to a moral hazard by doing business with clients´ money, what in the past due to numerous financial crises resulting in bank bankruptcies caused a loss of life-time savings of thousands of clients. By the reason of that, banking industry is nowadays one of the mostly regulated.

Local bank Regulators are central banks, which are incorporating to local provisions the recommendations of the Basel Committee on Banking Supervision legally presented in the relevant European Union Directives . The Basel standards began to be issued by Basel Committee in 1988 by Basel I. Basel I set the requirements for capital adequacy calculation, considering only one main risk – Credit risk. Basel I was the breakthrough in bank regulations, but despite numerous amendments and updates proved to be insufficient. Out of that reason in 2006 was introduced Basel II – three pillars system. Pillar 1 set the requirements on capital adequacy calculation concerning wider scope of risks – credit risk, operational risk and market risk. Pillar 2 set the supervisory review process by the means of enlarging the scope of risk management in every bank by taking into consideration other bank relevant risk, which

[18] Mgr. Michal Medo, external doctorial strudent,Comenius University in Bratislava, Faculty of Management
Mgr. Paulina Stachová, PhD. Comenius University in Bratislava, Faculty of Management.

among others are business risk, reputational risk, strategic risk, systematic risk etc. Pillar 3 – Market discipline, provided requirements on banks´disclosure, by which was contemplating the two previous Pillars.

Basel II, being exercised, by severe financial crisis from 2008 turned out to be insufficient for current global and turbulent banking environment and after several updates was in 2013 replaced by Basel III. Basel III has kept on three pillars principle and their content, but has toughen the capital adequacy calculation and widen its scope among others by introduction of new liquidity ratios, consideration of counter-party risk and implementation of buffers creation system. It enhanced also Pillar II activities and scope of Pillar 3 disclosure.

This paper focuses on Pillar 3, which in a comparison of Basel II and III remained to be the least modified, but very important in playing the role of winning back the harmed reliability of banking industry. The main aim of the paper is to compare the execution of the Pillar 3 by the three locally most important banks in Slovakia with the best practices identified by EBA review as of 2012 to identify the most important room for the sample banks disclosure improvements.

2. Regulation – Pillar 3

Since 1st of January 2013 banking sector is being regulated by the Basel III standards. Basel III consists of 3 pillars:

- Pillar 1 sets the requirements for capital calculation and Capital adequacy assessment
- Pillar 2 is via ICAAP (Internal Capital Adequacy Assessment Process) widening the scope of Risk management within a bank
- Pillar 3 also called Market discipline complements two previous Pillars and sets the requirements on information disclosure of a bank.

The Pillar 3 disclosure requirements provide a consistent set of principles and guidelines that might be used by local regulators as fundamentals for bank disclosure requirements. By the means of principles is understood to encourage market discipline by providing information, to allow market participants assess capital adequacy, financial and risk position of a bank and to enhance the reliability of financial sector by providing actual information and figures, which are being used by decision making of senior management and board. Guidelines are providing the manual for disclosure of qualitative and quantitative information with regards to the scope of application, capital assessment, risk exposure, securitization and remuneration (BCBS, 2011). Various reviews and researches on Pillar 3 have been recently conducted and most of them have one in common and it is that last financial crisis proved numerous of shortcomings of Market discipline system. One of the most interesting opinions was provided by Stephanou who studied Pillar 3 reports during the financial crisis and revealed that the key issue of Market discipline reports is how to operationalize and institutionalize it within different financial system structures. His proposal was to look at this issue from the perspective of four interrelated building blocks:

1. Information and disclosure
2. Market participants
3. Discipline mechanism
4. Internal governance

The concept of Pillar 3, according to Stephanou cannot succeed unless the coherence of all the interrelated building blocks is in place (Stephanou, 2010).

Our paper focuses on interrelation between information and disclosure and market participants, because as the Basel Committee on Banking Supervision believes, so we do, that to truthfully inform market participants about the overall financial and risk situation of a bank is on one hand improving the reliability of the whole financial sector, on the other by setting up of common structure or patterns to be followed of information disclosure it might create consistent and comprehensive system of potential comparability of banks (BCBS, 2011).

3. EBA follow-up review

EBA (European Banking Authority) is regularly assessing Pillar 3 reports of the high importance European banks and monitoring their compliance with the requirements of Basel regulatory standards issuer – Basel Committee on Bank Supervision. This analysis is being carried out since 2008 and depicts how Banks comply with the Pillar 3 disclosure requirements of subjected Capital Requirements Directive (CRD).

The analysis focuses on the areas, in which there was identified the need for improvement in previous assessments. The last year focus and as well our focus will be on the following specific disclosure areas:

- own funds,
- credit risk -Internal Rating Based (IRB) approach,
- market risk,
- remuneration.

One of the main challenges that comes out of the EBA - Pillar 3 assessments, regardless the requirements itself, is better comparability of disclosures between credit institutions. The EBA still believes greater comparability or some standardization would enhance the benefits of Pillar 3 information for users (EBA,

2012) This EBA notice is as well backed up by the results of dialogue with rating agencies and analysts, who consider the lack of comparability, comprehensiveness and transparency of the Pillar 3 disclosures to be one of the main issues.

Despite the fact, that credit institutions are against the adoption of standardization of Pillar 3 disclosures, because they don't see it beneficial enough, but rather costly and time consuming and also currently there is no discussion at the level of regulators, which would lead to implementing of standardized formats to Pillar 3 reports, EBA is trying via their assessment methodology identify and promote the banks with the best practices in certain areas of Pillar 3 disclosures and inspire other banks to follow their pattern.

In our paper we concentrate on comparison of the Pillar 3 best practices with the chosen sample of Slovak banks, identification of the major shortcomings and proposal of improvements.

4. Research methodology

Research goal

The goal of a research is to offer a perspective on Pillar 3 reports of Slovak banks in a light of comparison of their extent and quality with identified world best practices in chosen fields of disclosure. The primary method of this paper is qualitative review of Pillar 3 reports of banks sample in order to get in-depth knowledge of their content, followed by qualitative comparative analysis of chosen fields of disclosure with EBA-identified best practices.

Sample

For the purposes of analysis have been chosen three of the major banks in Slovakia, all of them are universal banks with wide variety of services and products offered and are part of international banking groups:

- Tatra Bank – established in 1990, part of the RBI Group (Raiffeisen Bank International AG),
- UniCredit Bank Slovakia a.s. – established by merger of UniBanka, a.s. and HVB Bank Slovakia, a.s. in 2007, part of the UniCredit group.
- VUB Bank, established in 1990, part of the Group Intensa Holding Sanpaolo International S.A. Luxembourg.

5. Results

General Observations

a. Timeframe and Frequency

The current regulatory standards do not specify any deadlines of Pillar 3 disclosures, but are expecting banks to publish them as soon as applicable. On the other hand the national regulators are encouraged to set the deadlines.

It is not very common that national supervisors do that, but Slovak national regulator – National Bank of Slovakia is one of the exemptions with deadlines being set up.

National Bank of Slovakia according to decree 19/2011 about the Banks' information disclosure has set up different timeframes for different frequency of reporting (NBS, 2011):

- Quarter reports have to be published within 30 days from the last day of the 1st, 2nd and 3rd quarter and within 90 days from the last day of the 4th quarter. This applies for all the information under §1 decree 15/2010 with an exemption to:
    - information about the financial parameters of the foreign bank's branch,
    - information about the structure of consolidated group,
    - information about the financial parameters of consolidated group,
    - strategy and process of managing of the risks, that bank is exposed to,
    - basis of consolidation for accounting and prudential purposes,
    - paragraph 1, section 12 letters j) to m) – credit risk management,
    - bank's targets in securitization,
    - information about the process of credit risk mitigation – paragraph 1, section 21, letters a) and b).
- Half-year reports have to be published:
    - within 30 days from the last day of the 1st half-year and within 90 days from the last day of the 2nd half-year. These requirements concern the following information:

        - strategy and process of managing risks, that bank is exposed to,
        - paragraph 1, section 12 letters j) to m) – credit risk management,
        - bank's targets in securitization,
        - information about the process of credit risk mitigation – paragraph 1, section 21, letters a) and b).
    - within 70 days from the last day of the 1st half-year and within 120 days from the last day of the 2nd half-year:
        - information about the structure of consolidated group,
        - information about the financial parameters of consolidated group,
        - basis of consolidation for accounting and prudential purposes.
- Following year-end information have to be published:
    - within 120 days from last day of a year:
        - annual accounts of foreign bank,
        - annual report of foreign bank,
        - statement of the person responsible for the audit verification of annual accounts of foreign bank.
    - within 150 days from the last day of a year:
        - consolidated annual accounts of foreign bank,
        - consolidated annual reports of foreign bank,
        - statement of the person responsible for the audit verification of the consolidated annual accounts of foreign bank.

All the banks in our sample did fulfill the timeframe and frequency requirements according to decree19/2011, §2, sections 3-5.

b. Presentation and Location

According to many Pillar 3 reviewers, the best practice of presentation of the information is to publish the stand alone reports, including all the areas of disclosure at one place and at one time.

VUB Bank and UniCredit Bank Slovakia are perfect examples of the location-best practices by producing the stand-alone Pillar 3 reports. Tatra Bank is publishing five separate reports (General Information, Financial Parameters, Bank Shareholders, Scope of application and Risk information) with as well certain cross-references to Annual report.

The national regulator by the decree 19/2011is only requiring banks to disclose Pillar 3 information publically. All of three banks in the sample, as well as the very prevailing majority of all the banks, are publishing the Pillar 3 reports on their website, what is currently the best practice of easing an accessibility of the disclosures.

c. Language Publication

Even though the national regulators as well as the Bank for International Settlements are not officially requiring to have Pillar 3 reports published in other than domestic language, English is being considered as a necessity, especially for the international active banks.

What considers our sample; the VUB Bank and UniCredit Bank have their Pillar 3 reports published both in Slovak and also in English languages, both of them produced at the same time. Tatra Bank, this year so far, has Pillar 3 disclosures only published in Slovak language, what we consider to be a significant short-coming.

d. Audit verification

Audit verification of the Pillar 3 reports is officially required in a very few countries. National Bank of Slovakia doesn’t have it set by law, so it can be done only on a voluntary basis, for instance to ensure accuracy and trustworthiness of the information. None of the Slovak banks in our sample has their reports audited by external auditor.

Specific observations

a. Own Funds

To reach the full compliance with the CRD requirements in the field of Own funds information disclosure is not an easy task, although what concerns the EBA sample of assessment most of the banks have been assessed as sufficiently compliant. Out of the identified best practices, we have chosen, for our purposes of comparison, the bank – Intensa SanPaolo.

Intensa SanPaolo has been identified as a best practice by EBA, besides the fact that complies with the fundamental CRD requirements, also due to an extensive approach in qualitative and thus explanatory disclosures of all aspects of the own fund information. Specifically what was even above the CRD expectations are disclosures on the reconciliation between IFRS equity and prudential own funds, informative disclosures on regulatory capital and its components and details disclosure on the available for sale revaluation reserves, which are providing information on unrealized gains or losses that are recognized in the equity.

VUB Bank as well as its mother bank – Intensa SanPaolo fully complies with the CRD requirements of own funds disclosures. However in some points there are certain areas of improvement especially in the qualitative disclosure of information. Unlikely other banks of our sample, VUB Bank provides the reconciliation between IFRS equity and prudential own funds, but only in quantitative manners, some further qualitative explanations would be welcome. Other pitfall of own funds disclosure is no qualitative detail or clear explanation provided on capital deductions, it is simply reported along with the effects on Tier 1 and Tier 2 capital.

UniCredit Bank provides only a brief quantitative disclosure of own funds distribution. Among others it lacks information of national regulation specifics, any clearer deduction disclosures or any more comprehensive and explanatory qualitative information. Summing up, the own funds disclosure of UniCredit Bank would be assessed as broadly complaint or even insufficient, that needs significant improvement.

Tatra Bank is in its Pillar 3 report only referring for own funds to Annual report and its notes. Annual report and its notes provide from the own funds disclosure perspective only fundamental breakdown of the own funds and subordinated debt with only qualitative description of shareholders' rights. In this manner, Tatra Bank comparatively to UniCredit Bank almost insufficiently reaches compliance with the fundamental CRD requirements on this area of disclosure with no qualitative explanations, no national regulation specifics, no own funds deduction disclosure, no reconciliation between IFRS equity and prudential own funds and other lacking specific requirements and recommendations.

b. Credit Risk - Internal Rating Based Approach

The EBA analysis of Credit Risk – IRB Pillar 3 disclosures proved that majority of assessed credit institutions should need some improvement in this area of disclosure. There is no a single bank out of the whole EBA sample of assessment which would fully comply with all of the CRD requirements and EBA recommendations. Out of this sample, the bank that has come nearest to the point, where it would be identified as the fully complied best practice is Société Générale.

Société Générale was identified to be the best practice besides conforming the CRD relevant requirements mainly due to clear disclosure of internal rating process and models with clear link between internal and external ratings. Unlikely it was by the majority of other reviewed banks, Société Générale also provided comprehensive identification of the scope of application of the IRB approach by subsidiary and presentation of EA/EAD ratio and its back testing.

VUB Bank overall would be assessed as sufficient, even above sufficient in its Credit Risk IRB approach disclosure. Generally is disclosing Credit Risk problematic very widely with the focus on qualitative disclosure, thus explanation, of every relevant quantitative disclosure. IRB approach model was in VUB presented on December 30th, 2009 for the use of FIRB on Corporate exposures, authorization was received on December 2010 and February 2011. In December 2011 VUB submitted the IRB application for retail mortgage portfolio. The Bank plans to apply IRB models for retail – small business, banks and AIRB for corporate in seconds semester 2013. The application for other areas will come in due in next years. What concerns the EBA findings in its assessment and main pitfalls applied on VUB Bank, the information provided on impaired exposures is structured by type of obligor and geographic area, what is even when lacking any qualitative explanation or differentiating between standardized and IRB approach credit granting, quite improvement by a comparison to banks in EBA assessment sample. Although currently is IRB model applied only in Corporate segment and in Retail residential mortgage segment, the full disclosure of all required information should be in place. By this means, it lacks providing any information on back testing or any qualitative disclosure on internal ratings and its link to external ratings, what are then the main deficiencies of VUB Credit risk – IRB approach disclosure.

UniCredit Bank's disclosures, including the one on Credit Risk – IRB approach, are not of a very standard structure. That is generally a bit of a pitfall, but besides, what concerns Credit Risk – IRB approach disclosure UniCredit Bank offers a wide and sufficiently conforming spectrum of qualitative information disclosed with certain cross references to Annual reports, but what is missing is a more informative disclosure on IRB system itself and its comparison with Standardized approach. Even though the bank obtained the approval to use foundation approach of internal ratings since July 1st 2012, it is being used as an excuse of not providing some of the information. Among those are impairment disclosures for credit exposure without differentiating between those under IRB and those under Standard approach, no back testing, so the comparison of expected loss and real loss and no link between IRB and Standard approach by the means of ratings explanation or any other further quantitative information of ratings granting by the IRB approach.

Tatra Bank, what is in its favor, is that unlikely the other banks of our assessment sample is the only one that provides the impairment disclosure for credit exposure with differentiating between those under IRB and those under Standardized approach. Tatra Bank is using IRB model since 2009 and also that might be a reason why, when comparing to other banks of our sample, provides Tatra Bank more detailed quantitative and qualitative disclosure of its model. Although some of the parameters are indicating the comparison between Standardized and IRB approach ratings, the clear link between those two is still missing. Another deficiency is only qualitative disclosure of IRB data back testing, though the differences between probable defaults and real defaults are described, the description is superficial, not very informative and some wider especially quantitative disclosures would be welcome here.

c. Market Risk

In the whole EBA sample only approximately 26% of all banks did fully comply with all market risk disclosure requirements. Out of those as a best practice bank was identified UniCredit Group.

UniCredit Group overall sufficiently complies with the CRD requirements on Market Risk disclosure, but what was above the average and what caused that UniCredit Group was identified as the best practice is the extensive, clear and detailed explanation of the internal model used and internal validation process, clear description of stress test and scenario analysis and detailed disclosure on VaR back-testing, analysis and clear explanation between P/L and VaR overshooting.

VUB Bank, what is a benefit, provides clear and very detailed qualitative information on the system VaR and SVaR calculations, as well as theoretical background of Back testing and Stress testing, but what it lacks is any or sufficiently full disclosure on many required areas:

- procedures and methodologies for valuation of trading book positions,
- incremental risk charge, comprehensive risk measure and the stressed VaR measure,
- breakdown of market risk capital requirements by different risk types,
- quantitatively depicted VaR back-testing and stress testing with real data input.

UniCredit Bank and Tatra Bank in their Pillar 3 disclosures on Market Risk set, that they do not use its own model for market risk calculation.

d. Remuneration

Requirements for remuneration disclosures were only introduced by the Basel Committee on Banking Supervision as a part Enhancements to the Basel II framework in July 2009. It was intended to address a supplemental guidance to a numerous risk management weaknesses revealed during the financial crisis that began in 2008. As it is one of the newest areas of CRD-required disclosure, is there tangible very significant improvement over the years of assessment. In 2010 in the EBA Pillar 3 follow up review none of the banks in the sample of assessment fully complied with the CRD requirements, what on the contrary in the last year of assessment represented 38% of banks providing adequate disclosures, from where 19% were identified as the best practices. For our purposes of analysis, we have chosen as the best practice out of EBA sample – Deutsche Bank.

Deutsche Bank was identified to be the best practice, besides fully reaching the compliance with the CRD requirements, also because of providing comprehensive information on aspects of remuneration, such as compensation governance, compensation scheme and employees involved.

VUB Bank doesn't provide in any of the reports any closer disclosures on remuneration or compensation methodologies, besides brief description of the functioning of a remuneration committee.

UniCredit Bank's disclosure on remuneration would be assessed as conforming the CRD requirement but needs improvement. It provides information on the structure of compensation committee, although the graphically depiction would be welcome, as well it provides adequate information concerning the decision-making process used for determination of the remuneration policy, criteria of evaluation individual performance and information on link between bonuses and an individual performance. What it lacks and where are found the most deficiencies in UniCredit Bank's disclosure are any aggregate quantitative information on remuneration (broken down by business areas or hierarchy levels of the employees) and any more details of all of the areas of remuneration disclosure, because even though they are covered in bank's Pillar 3 report they are not very informative and provide a very low level of detail.

Tatra Bank, like UniCredit Bank provides disclosure on information from almost every required category, but again with a very low level of detail and also it misses quantitative information as it has been described above. When comparing to UniCredit Bank's disclosure the majority of deficiencies in Tatra Bank's report are in the description of structure of compensation committee, the decision-making process used in setting the compensation policy, criteria of evaluation of performance and link between performance and bonuses, which are not adequately described, not very informative and in some compulsory cases only providing references to internal documents.

6. Discussion and Conclusion

This paper is discussing highly topical issue of current banking environment and it is regulation and its interpretation in the field of information disclosure. Out of all 3 pillars of Basel standards is Pillar 3 providing to banks the widest space for interpretation and implementation of its requirements in their reports.

Basel Committee, EBA and as well many experts think that some of the standardization of Pillar 3 reports would enhance their readiness, reliability and in the end willing comparability of banks´ financial and risk positions among different economical environments, but as long as that at least for now is not a topic of discussion of Basel Committee some of the improvements in this area are only global periodical assessments of the quality of Pillar 3 reports.

Our paper is analyzing the Pillar 3 reports of chosen Slovak banks and their compliance to CRD requirements in a comparison with EBA identified the best practices of EBA Pillar 3 regular annual review as of 2012. As an output of this analysis recommendations to Slovak banks are provided for improvement of their information disclosure quality and extent in chosen fields of disclosure.

The only limitation of a paper is availability of EBA Pillar 3 review report from 2012 (examining 2011 Pillar 3 reports) in a perspective of Basel III implementation in 2013, but as has already been stated in introduction section, the difference between Basel II and Basel III in Pillar 3 is insignificant and data used for our research are absolutely relevant.

The benefits of the paper are that it provides comprehensive and overall view on the Slovak banks´ Pillar 3 reports, on their quality and extent, plus as a result of comparative analysis with best practices in bank reporting it provides recommendations for Slovak banks, potentially leading to significant improvement of the quality of their reports and thus their reliability.

6. Acknowledgements

This study was realized as a part of the research project Vega 1/0392/13 „Modelling of Stakeholders` Behaviour in Commercial Bank during the Recent Financial Crisis and Expectations of Basel Regulations under Pillar 3- Market Discipline“.

References

[1] ACCENTURE: Basel III Handbook, 2012.

[2] BASEL COMMITTEE ON BANKING SUPERVISION: International Convergence of Capital Measurement and Capital Standards, 2006.

[3] BASEL COMMITTEE ON BANKING SUPERVISION: Basel III: A global regulatory framework for more resilient banks and banking systems Bank for International Settlements, 2011.

[4] BASEL COMMITTEE ON BANKING SUPERVISION: Working Paper on Pillar 3 – Market Discipline, 2001.

[5] BASEL COMMITTEE ON BANKING SUPERVISION: Pillar 3 Disclosure Requirements for Remuneration, 2011.

[6] DIRECTIVE 2013/36/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on access to the activity of credit institutions and the

prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

[7] EUROPEAN BANKING AUTHORITY: Follow-up review of banks‘transparency in their 2011 Pillar 3 reports, 2012.

[8] NATIONAL BANK OF SLOVAKIA, Decree of the National Bank of Slovakia of 21 September 2010 No. 15/2010 on disclosures by banks and branches of foreign banks adjusted to the Provision of NBS, 19/2011,2011.

[9] STEPHANOU, C.: Rethinking market discipline in banking: lessons from the financial crisis, 2010.

[10] VAN GREUNING, H. - BRATANOVIC, S. B.: Analyzing Banking Risk, 2009.

Pillar 3 reports:

1. Deutsche Bank
2. Intensa SanPaolo
3. Société Générale
4. Tatra Bank
5. UniCredit Bank
6. UniCredit Group
7. VUB Bank