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Pillar 3 disclosures: looking back and looking forward

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Pillar 3 disclosures: looking back and looking forward

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- Public disclosure by banks and insurers of information about their financial position, risk profile and corporate governance practices is an important component of a well-functioning financial system.
- Inadequate disclosures contributed to the financial crisis. As a consequence, improving banks' and insurers' disclosures has been a major focus of post-crisis regulation.
- This article takes stock of the enhancements made to Pillar 3 disclosures since the financial crisis, and considers what progress could be made in the future.

Overview

In order for markets to operate effectively investors need access to information about financial institutions' risk profiles. Banks' and insurers' disclosures provide an important channel through which relevant information can be obtained. Market participants can then use this information to influence the behaviour of firms in which they invest, allowing risks to be assessed and priced accurately — a mechanism known as market discipline.

During the financial crisis it became clear that existing disclosure regimes were deficient: the Basel Committee on Banking Supervision concluded that the existing disclosure framework had 'failed to promote the identification of a bank's material risks and did not provide sufficient, and sufficiently comparable, information to enable market participants to assess a bank's overall capital adequacy and to compare it with its peers'.[2]

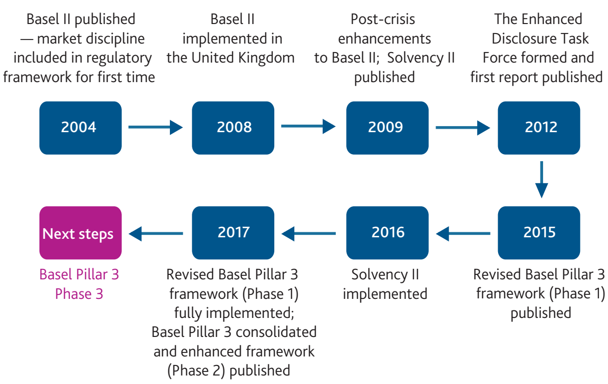
In response, a number of international and domestic initiatives have been introduced post crisis to enhance banks' disclosure practices. These have generally been introduced on an *ad-hoc* basis to meet specific needs or shortfalls in existing disclosures.

There is currently no international disclosure standard for the insurance industry, but the implementation of Solvency II in Europe has resulted in a more consistent approach to transparency across the sector.

This article provides an overview of the improvements to Pillar 3 disclosures by both banks and insurers since the crisis, and discusses the existing gaps in the financial sector's disclosure frameworks by analysing similarities and differences between the multiple initiatives.[3]

The article also explores the potential for further work on the scope of Pillar 3 disclosures. It focuses in particular on the possibility of basing the scope of future disclosures on regulatory reporting requirements, and what restrictions might apply to such an approach. The method for future disclosures is also considered, with emphasis on disclosure location, format and assurance.

Summary figure Timeline of disclosure initiatives



(1) The authors would like to thank Alan Ball, Bill Francis, Danielle Martis, Jungphil Park and Aaron Shiret for their help in producing this article.
(2) Basel Committee on Banking Supervision (2015).
(3) This article relates to Pillar 3 disclosures only and firms should note that other regulatory disclosure requirements, such as the Market Abuse Regulation requirements associated with inside information, may apply.

The economics of disclosure

An important component of a well-functioning financial system is the ability of market participants to monitor the firms in which they invest. In order to do so, the market needs access to information about the risks to which firms are exposed — this is the purpose of banks' and insurers' public disclosures. Disclosures should allow investors to price these risks accurately, thereby influencing the behaviour of firms: the process of market discipline.

Economic theory suggests that capital markets already provide substantial incentives for firms to disclose information voluntarily, such as the ability to lower their cost of capital.(1) But while a voluntary, uncoordinated system will lead to firms disclosing some information, this does not necessarily mean that the level of disclosure will be economically efficient: firms may still prioritise profit maximisation over social welfare. Added to this, market failures can affect both the level of firms' voluntary disclosure and the optimal level of disclosure.

The main market failures that typically justify regulation of disclosure include externalities, information asymmetries and co-ordination failures. Disclosure can generate the positive externality of increased market confidence by reducing the information asymmetries between firms and investors. But without regulation banks and insurers may disclose less information than is socially optimal: asymmetries arise because private incentives for firms to disclose information are too weak or the fear of adverse effects of disclosure is too strong. This is likely to be pronounced during more volatile market conditions such as a financial crisis: in an attempt to manage market responses or dampen potential market overreaction, the incentives to obscure information disclosures may increase. Moreover, if firms lack certainty about their position relative to other institutions and fear that disclosing information may increase their funding costs, the perceived costs of disclosure may outweigh the perceived benefits.

Co-ordination failure can lead to banks and insurers not providing comparable information because they have no mechanism or incentive to co-operate over disclosures. Furthermore, external factors like discretions allowed under capital regulations also make it difficult for investors and creditors to assess a bank's or insurer's risk profile and to compare risks across firms.

Effective disclosure regulation can help to mitigate these problems. For example, requiring firms to disclose information using standard definitions via standardised templates allows market participants to compare firms much more easily.

Nevertheless there are a number of obstacles that interfere with transparency which, in turn, impede effective market discipline. Expectations of government support, either explicitly (for example through deposit guarantee schemes) or implicitly (via government bailouts) may reduce bank creditors' incentives to use, scrutinise and demand information on bank conditions. Ongoing policy efforts aimed at ensuring that banks hold sufficient amounts and types of bail-in capital, and develop credible recovery and resolution plans, are designed to reduce this obstacle and bolster market discipline.

The extent to which market participants can process and analyse disclosed information is also key. If investors are incapable of using the data effectively, it would suggest that more disclosure is not always better for transparency. In fact, if the market is flooded with increasing volumes of impenetrable data, the risk that useful information is drowned out grows.

There are also potential negative consequences of particular disclosures. For example, disclosing information about banks' liquidity too frequently or without a sufficient time-lag could draw attention to and thus worsen any short-term liquidity

(1) For a comprehensive overview of the theoretical motivations for and a discussion of the empirical evidence on these incentives, see Leuz and Wysocki (2016).

Key concepts

Disclosure, transparency and market discipline are terms frequently used in conjunction with each other, and sometimes (erroneously) as synonyms. It is important to understand the relationship between the three concepts.

Disclosure is the act of providing information to the market, while transparency arises only if the information is reliable and can be appropriately interpreted and used by the market. It is this concept of transparency that underpins effective market discipline.

In broad terms, market discipline is the mechanism by which market participants (eg shareholders, debt holders, depositors) monitor and discipline, through price and quantity responses, excessive risk-taking. At a more detailed level, market discipline refers to the role that such stakeholders play in shaping firms' risk-taking behaviour by demanding higher risk premiums on the funds they provide or by reducing the amount of funding they supply outright to firms. Market discipline therefore comprises two key components: *monitoring and influencing*.(1)

(1) There is widespread agreement across the academic literature that market discipline involves these two main components. For a summary see Eling (2012).

issues. Data which prematurely reveal that a firm is accessing central bank liquidity assistance could create or exacerbate uncertainty about the true health of the firm, undermining market and depositor confidence. Such risks might be heightened during periods of stress.

The global financial crisis provides a case study for analysing the consequences of ineffective disclosures, and highlights the benefits of an enhanced disclosure framework for banking and insurance.

Disclosure and the financial crisis

The opacity of banks and insurance firms can make them difficult to assess without considerable information on their financial position, risk-taking behaviour and corporate governance practices.(1) Furthermore, while firms' financial reports provide valuable information on their financial position, they do not include the necessary information to assess or compare banks' and insurers' capital adequacy.

This opacity contributed to the global financial crisis by magnifying uncertainty about the underlying value of assets and exposures. This prevented market participants from distinguishing between high-risk and low-risk institutions. Heightened fears about banks' financial condition left counterparties unwilling to trade, and funding costs rose even for healthier banks.

By contrast, in the run-up to the crisis (when market perceptions about the condition of banks were generally high), the same lack of transparency led market participants to supply funds not only to healthy (less risky) banks but also to unsound (more risky) banks on similar terms. This allowed banks to access funding that was misaligned with their underlying risks. This mispricing contributed to the severity of the crisis.

In response to the crisis, regulators have focused on enhancing disclosures in order to increase transparency and to foster market discipline. The intended effects are to reduce the likelihood and severity of financial crises and promote financial stability more widely.

Banking disclosure initiatives

Since the crisis there have been a number of policy developments, both international and domestic, aimed at improving the disclosures of banks and insurers. **Figure 1** maps these various initiatives for banks.

At an international level, disclosure initiatives have been implemented by both the Basel Committee on Banking Supervision (BCBS), through Pillar 3 of the Basel Accords, and the Enhanced Disclosure Task Force (EDTF), under the auspices of the Financial Stability Board (FSB). There are overlaps

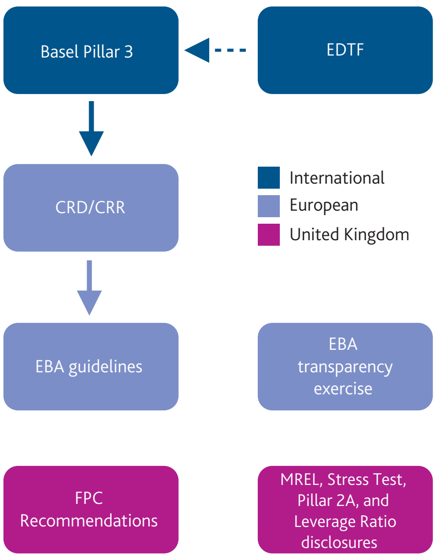
Financial reporting, regulatory reporting and regulatory (Pillar 3) disclosure

Financial reporting information is drawn from accounting data, and published in audited financial statements like the annual report. In the United Kingdom firms' financial reporting is regulated by the Financial Reporting Council.

Regulatory reporting refers to the private data collected from firms for supervisory purposes. For banks in the European Union this information is largely comprised of financial reporting templates knowns as FINREP, and capital reporting templates, called COREP, based on the CRR and CRD IV. For insurers, regulatory reporting is mandated through Solvency II. In addition to collecting these, the Bank of England's Prudential Regulation Authority also requests national-specific data. Regulatory reporting provides supervisors with information on firms' risk exposures, and capital and liquidity positions. In general, regulatory reporting is not currently made public.

Prudential regulatory disclosure, referred to as Pillar 3 in both the Basel Accords and Solvency II, is the prudential information that firms must make publicly available. As with regulatory reporting, this includes data on capital adequacy and the different kinds of risks that a firm faces.

Figure 1 Banking disclosure initiatives



(1) See Morgan (2002), Flannery, Kwan and Nimalendram (2013) for banks; Eling (2012) provides an overview of market discipline in insurance.

between the work of Basel and the EDTF, and the BCBS built on relevant EDTF recommendations when drafting its Pillar 3 review. Nevertheless they have different scopes and objectives: the purpose of the Basel review of Pillar 3 is to overhaul the existing regulatory disclosure requirements, whereas the EDTF's recommendations for enhanced disclosures aim to improve banks' current disclosure practices. Basel Pillar 3 requirements, with their focus on the regulatory measurement of risks and capital adequacy, have a narrower scope than the EDTF's recommendations, which cover disclosures relating to the internal, regulatory and accounting measurement of risks.(1)

At the European level, the Basel Pillar 3 regulatory framework is implemented through the Capital Requirements Directive and Regulation IV (CRD and CRR respectively). The European Banking Authority (EBA) has published disclosure guidelines, and conducts an annual EU-wide transparency exercise.

In the United Kingdom, the Bank of England's Financial Policy Committee (FPC) has issued Recommendations relating to disclosure. The Bank has also published policy on a wide variety of disclosure requirements. The following section explains these multi-level disclosure initiatives in more detail.

Enhanced Disclosure Task Force

In 2012 the FSB announced the formation of the EDTF. Membership of the EDTF was drawn from the private sector, with representatives from asset management firms, global banks, credit rating agencies and external auditors, as well as investors and analysts. This direct input from industry sets the EDTF apart from other disclosure initiatives, and helped to achieve buy-in from across the banking sector.

In its first report the EDTF noted that the sheer volume of disjointed disclosures made by banks made it difficult to find relevant information and to assess more comprehensively a bank's risks. Vague, complex or legalistic language also played a significant role in making these disclosures difficult to understand.

In order to address these issues, the EDTF published a list of seven fundamental principles for disclosure (**Table A**).

Table A The EDTF's fundamental principles for disclosure

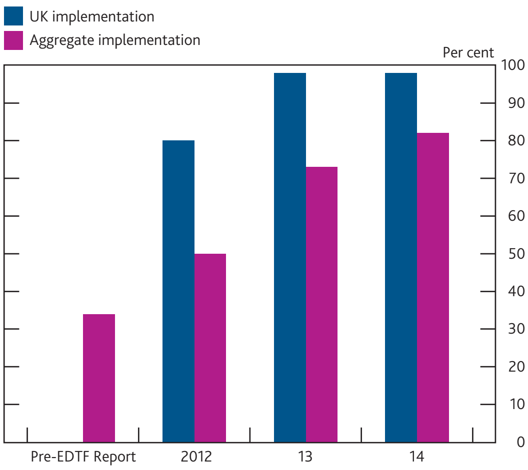
(1) Disclosures should be clear, balanced and understandable.
(2) Disclosures should be comprehensive and include all of the bank's key activities and risks.
(3) Disclosures should present relevant information.
(4) Disclosures should reflect how the bank manages its risks.
(5) Disclosures should be consistent over time.
(6) Disclosures should be comparable among banks.
(7) Disclosures should be provided on a timely basis.

Alongside the fundamental principles, the EDTF produced 32 detailed recommendations for improving banks' disclosures, organised into the following categories:

- general;
- risk governance and risk management strategies/business model;
- capital adequacy and risk-weighted assets;
- liquidity;
- funding;
- market risk;
- credit risk; and
- other risks.(2)

The EDTF issued progress reports in 2013, 2014 and 2015 to assess the level and quality of the implementation of their recommendations. **Chart 1** shows the progress that participating banks have made in improving their disclosure practices. These reports also highlighted instances of good practice among the participating banks, with the aim of improving sector-wide quality, consistency and comparability.(3)

Chart 1 Percentage of EDTF recommendations disclosed by participating banks



Sources: Enhanced Disclosure Task Force (2013, 2014 and 2015).

The figures in **Chart 1** are based on banks' self-assessment of the level to which they follow the EDTF's recommendations. There has been a steady increase in take-up, although it must be noted that in the 2015 Progress Report the EDTF's own User Group reviewed these self-assessments and found levels of implementation lower than participating banks had reported themselves. This was the case for credit risk in particular and specifically for disclosures about derivatives and off balance sheet exposures. Nevertheless, for both self-assessment and User Group review, the United Kingdom

(1) Basel Committee on Banking Supervision (2014) includes a detailed comparison of EDTF recommendations and the revised Basel Pillar 3 requirements.
(2) Enhanced Disclosure Task Force (2012).
(3) The participating banks are listed in Enhanced Disclosure Task Force (2015).

was ranked in the top 2 for comprehensiveness of implementation across all categories.

Basel Pillar 3

With the publication of the Basel II Accord in 2004, market discipline became the third pillar of banking regulation. Its purpose was to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). Pillar 3 was designed to make it simpler for market participants to assess a bank's capital adequacy. This was particularly relevant under the Basel II framework, which, by allowing banks to use their own methodologies, introduced a greater level of firm discretion in assessing their capital requirements.[1]

However, the high level of discretion built into the framework (such as the lack of templates) meant that banks were free to present information as they chose. This made it much harder to compare across banks, and made it easier for banks to obfuscate. The financial crisis revealed the deficiencies in the Basel II disclosure framework, and as a consequence, enhancements were made in 2009.[2] It is also important to note that even though Basel II was first published in 2004, it was not fully implemented in the United Kingdom until 2008 — after the start of the financial crisis.

Despite these post-crisis improvements, the BCBS decided to radically overhaul Pillar 3, and in January 2015 the Committee published its Revised Pillar 3 disclosure requirements[3] — so-called Phase 1 — as part of the new Basel III Accord. **Table B** sets out the principles guiding the new framework, which bear similarities to the EDTF's fundamental principles for disclosure.

Table B Basel guiding principles for banks' Pillar 3 disclosures

(1) Disclosures should be clear.
(2) Disclosures should be comprehensive.
(3) Disclosures should be meaningful to users.
(4) Disclosures should be consistent over time.
(5) Disclosures should be comparable across banks.

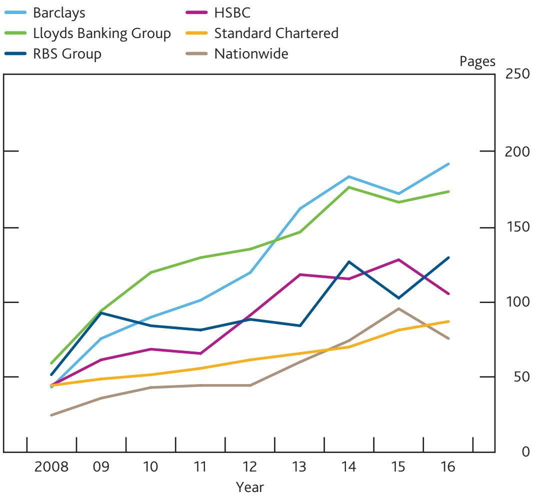
An important objective of the revised requirements is to improve comparability and consistency of disclosures. To this end, harmonised templates were introduced, based on the concept of a 'hierarchy' of disclosures. Fixed-form templates are used for quantitative information considered essential for the analysis of a bank's regulatory capital requirements. Tables with a more flexible format are used for information considered meaningful to the market but not central to the analysis of a bank's regulatory capital adequacy. To each of these templates senior management may add a qualitative commentary that explains a bank's particular circumstances and risk profile. Major UK banks published Pillar 3 disclosures in line with the new requirements for the first time as part of their end-2016 financial reporting.

A brief comparison of the disclosure requirements for credit risk in Basel II and Phase 1 of Basel III shows the extent of the change in the Basel disclosure framework. Basel II's credit risk disclosures were organised into five flexible-format tables, each containing quantitative and qualitative sections. By contrast, the credit risk disclosure requirements in Phase 1 comprise five flexible tables alongside ten templates with fixed formats which should be accompanied by a narrative commentary.

Phase 2 — the 'consolidated and enhanced framework' — was finalised and published in March 2017.[4] Of particular note are disclosure requirements relating to new policy developments such as the total loss-absorbing capacity (TLAC) for global systemically important banks (G-SIBs), which demonstrate an increasingly adaptive framework keeping pace with the changing regulatory landscape. **Figure 2** summarises the evolution of Basel's Pillar 3 requirements.

The new Pillar 3 framework has resulted in an increase in the amount of data disclosed to the market. As a result, since the crisis banks' Pillar 3 reports have grown significantly, as **Chart 2** shows.

Chart 2 Increasing length of banks' Pillar 3 reports[a]



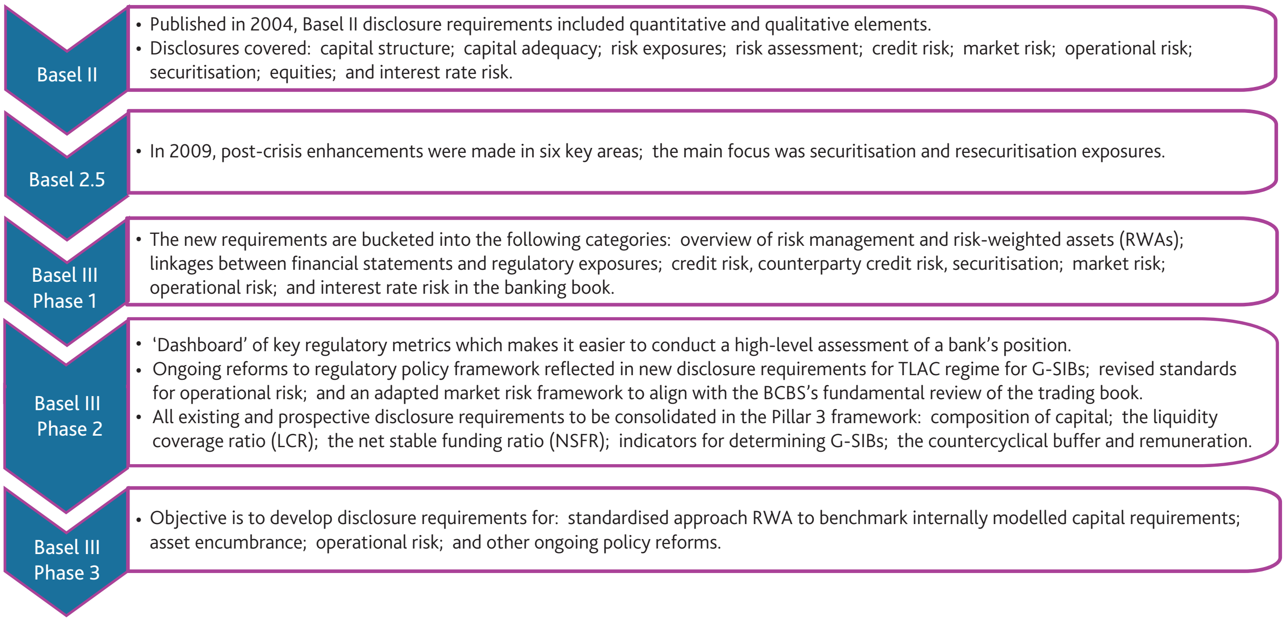
Source: Banks' Pillar 3 reports.

(a) This chart is based on the lengths of firms' main Pillar 3 document. But as firms are allowed to signpost disclosures that are being made in other documents in their Pillar 3 report, the figures are not necessarily comparable

Across the six largest UK banks and building societies, Pillar 3 reports have lengthened steadily. Increased volume of disclosures is not, however, necessarily beneficial of itself: disclosures must be meaningful and market participants able

(1) Basel Committee on Banking Supervision (2004).
(2) Basel Committee on Banking Supervision (2009).
(3) Basel Committee on Banking Supervision (2015).
(4) Basel Committee on Banking Supervision (2017).

Figure 2 The evolution of Basel Pillar 3



to use the information effectively. The large disparity in report length between banks also suggests that banks continue to present information in a wide variety of ways, which has a negative impact on the comparability of the disclosed data.

European implementation

Basel's Pillar 3 disclosure framework applies to UK banks, building societies and investment firms through Part Eight of the CRR. While the Basel standards and the CRR disclosure requirements are broadly aligned, areas of misalignment exist, which could result in unnecessary duplication or undermine the comparability and consistency of disclosures. As a consequence, in December 2016 the European Banking Authority (EBA) published Guidelines on disclosure requirements. These are designed to allow EU institutions to implement Phase 1 of the Pillar 3 reforms in a way that is compliant with Part Eight of the CRR.

Another major component of the EBA's approach to disclosure is its now annual EU-wide transparency exercise, first conducted in 2013. In 2016 this covered 131 banks from 24 countries, including the four largest UK banks. The exercise provides detailed bank-by-bank data covering capital, risk-weighted assets, profits and losses, credit risk, sovereign exposures, asset quality and market risk. These are published in a central location by the EBA, with interactive tools available for downloading and analysing the data.

Since 2015 the EBA has aimed to rely primarily on regulatory reporting data as the basis for the transparency exercise disclosures. This has a threefold benefit: first there are efficiency gains and burden reduction for banks and supervisors, as the data required for the exercise are already collected. Second, knowledge that the data are to be published leads to an improvement in the quality of the information submitted under the reporting framework. Third, this in turn leads to enhanced quality and consistency of the published data.[1]

Mindful of the potentially undue burden of increased disclosure on firms, the EBA has also published guidelines on materiality, confidentiality and proprietary information relating to disclosure (EBA (2014)).

UK-specific initiatives

The Bank of England's Financial Policy Committee (FPC) has taken an active interest in the role of disclosure in fostering financial stability, while remaining mindful of the financial stability risks of specific disclosures.[2]

In June 2013 the FPC recommended that all major UK banks and building societies should comply fully with the EDTF's recommendations in their 2013 annual reports. It also restated a recommendation to improve the comparability and consistency of the Pillar 3 disclosures of the major UK banks and building societies. These were intended to further improve the information available to investors, and make it easier for them to process information about banks' risk-taking, enhancing their ability to exert market discipline.

These Recommendations built on the earlier work of the Financial Services Authority to improve banks' disclosures: in particular by co-ordinating with the British Bankers' Association (BBA) in implementing the BBA Code to ensure banks' financial statements provide useful, high-quality information. In September 2014 the FPC judged that these Recommendations had been implemented, but noted that the

(1) European Banking Authority (2015).
(2) The FPC's approach to disclosure is detailed in Bank of England (2012).

Basel Pillar 3 review was ongoing. Therefore, the FPC agreed to look again at Pillar 3 disclosures following the completion of the Basel review and would then consider whether to take further action.

In recent years the Bank of England has focused on disclosure in a number of policy areas. The Bank discloses the results of its stress tests on both an aggregate and bank-by-bank basis,(1) and an assessment by the International Monetary Fund (IMF) in 2016 concluded that the Bank's stress-test disclosure regime successfully balanced the needs of information dissemination and information protection.(2)

In 2017 the Prudential Regulation Authority published a consultation proposing that firms should disclose their Total Capital Requirement, which would enable market participants to understand each firm's Pillar 2A capital requirement.(3) Pillar 2A capital requirements cover risks inadequately covered or not covered by Pillar 1. Disclosure allows investors to gauge how close a firm is to its Maximum Distributable Amount — the point at which a limitation is imposed on the payment of dividends.

Disclosure also plays a part in the Bank's strategy for solving the 'too big to fail' problem: the Bank has already published estimates of the indicative interim and final minimum requirement for own funds and eligible liabilities (MREL)for each of the United Kingdom's global and domestic systemically important banks. The Bank has also published estimates of the average of the indicative interim and final MRELs for eight other UK banks and building societies that currently have a resolution plan involving the use of resolution tools by the Bank (rather than reliance on the insolvency regime).(4) The Bank also intends to publish resolvability assessments for major banks by 2019.(5)

Disclosure is an important part of the UK leverage ratio framework too. Banks and building societies with retail deposits equal to or greater than £50 billion must disclose their leverage ratio, average exposure measure, average leverage ratios and countercyclical leverage ratio buffer on a quarterly basis.(6)

Insurance disclosure initiatives

In contrast to the banking industry, there is no co-ordinated international disclosure framework for insurance, in part because there is no international capital standard for insurers.

It is also true to say that the majority of academic research on disclosure has focused on the banking sector rather than insurance. Nevertheless, interest in improving transparency in the insurance industry is increasing.

The International Association of Insurance Supervisors (IAIS) has, for example, published its 'core principle' on public disclosure, which bears strong similarities to the Basel and EDTF principles, and is relevant for both firms and supervisors (**Table C**).(7) The principle also highlights the benefits of aligning methodologies for public disclosure with those used for regulatory reporting. However, while the IAIS's principle provides useful high-level expectations, it does not provide a specification of what data should be disclosed.

Table C IAIS core principle for public disclosure

Disclosures should be:

- decision useful to decisions taken by market participants;
- timely so as to be available and up-to-date at the time those decisions are made;
- comprehensive and meaningful;
- reliable as a basis upon which to make decisions;
- comparable between different insurers operating in the same market; and
- consistent over time so as to enable relevant trends to be discerned.

Solvency II

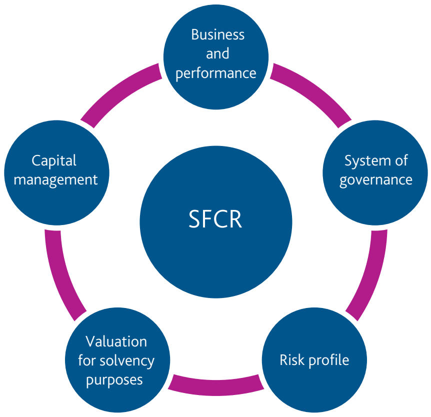
The introduction in 2016 of Solvency II across the European Union (EU) has gone some way to addressing the lack of supranational regulatory disclosure regime for insurers. Like the Basel framework for banks, Solvency II takes a 'three pillar' approach to regulation, with Pillar 3 focusing on regulatory reporting, disclosure and transparency. This explicit attention to market discipline marks a step change in insurance regulation: Solvency II places a far greater emphasis on public disclosure than previous regulatory frameworks.

The centrepiece of Solvency II's Pillar 3 is the Solvency and Financial Condition Report (SFCR). This is an annual report published by insurance and reinsurance firms themselves, which details their compliance with Solvency II. Firms can choose to disclose more than they are required to by Solvency II, and are free to present the required information as they wish; the report must, however, follow a basic five-part structure (**Figure 3**).(8) There are both qualitative and quantitative elements, including templates.

Part A should include disclosures about the firm's material lines of business and material geographical areas, as well as significant business events that have occurred over the reporting period. Qualitative and quantitative information about both the firm's underwriting and investment performance should also be disclosed.

(1) The Bank's approach to stress testing is explained in Bank of England (2015a).
(2) See IMF (2016). The same report also stated that the Bank's regime represents a good balance between the benefits and costs observed by Goldstein and Sapra (2013).
(3) See Bank of England (2017).
(4) See www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/mrel.aspx.
(5) See http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/capital-and-resolution/written/69208.pdf.
(6) Bank of England (2015b).
(7) See IAIS ICP 20, available at https://www.iaisweb.org/page/supervisory-material/icp-on-line-tool.
(8) The full structure of the SFCR and Regular Supervisory Report can be found in Commission Delegated Regulation (EU) 2015/35 (2014) Annex XX.

Figure 3 Solvency and Financial Condition Report



Part B concerns disclosures relating to Pillar 2, demonstrating how the three pillars of Solvency II are designed to complement and strengthen each other. Here firms should provide a review of another key document: the Own Risk and Solvency Assessment (ORSA). As well as risk management, this section also includes disclosures relating to the firm's management structure and its governance and remuneration policies.

Section C deals with the risks the firm faces and how it monitors and manages these. D includes disclosures about valuation of assets and liabilities and technical provisions.

The final section of the SFCR focuses on capital management. Here insurance firms must disclose the structure, amount and quality of own funds. They must also disclose detailed information about their Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR), two key metrics in the Solvency II regime. Firms must also provide an explanation if they fail to comply with the SCR and MCR.

The SFCR must also include disclosures explaining the methods used for internal model calculations, and any differences in the methods and assumptions between the Solvency II standard formula and the firm's internal model.

The structure and content of the SFCR also forms the basis of firms' private narrative reporting: the Regular Supervisory Report (RSR). The RSR is submitted to the regulator and includes confidential and more granular information. The shared structure of the SFCR and RSR demonstrates the alignment between reporting and disclosure requirements under Solvency II.

The PRA requires that certain elements of the SFCR be externally audited.(1) While this is not stipulated in the Solvency II Directive itself, EIOPA has publicly noted the benefits of externally auditing the main elements of the SFCR.(2)

While there is currently no international capital standard for insurers, jurisdictions outside the EU have taken note of Solvency II. For example, Switzerland now has an insurance regulatory framework equivalent to Solvency II, and in 2014 Hong Kong published a consultation on a three-pillar risk-based capital framework which would include detailed disclosure requirements for the first time.(3)

Potential for future work: content of disclosures

The purpose of regulatory reporting is broadly similar to the purpose of regulatory disclosures: to enable supervisors or investors respectively to understand the risks faced by firms. Regulators, however, have access to a greater range of data, which is also often more granular than the data available to the market. In the box on page 198 we compare existing disclosure requirements with regulatory reporting. Banks' COREP and FINREP returns are compared with annual reports and Pillar 3 reports; the same methodology is used for insurers' private and public Solvency II returns. Our gap analysis shows that currently only a limited proportion of the private reporting data received by supervisors is also accessible in some way to market participants.

Solvency II disclosure requirements, the EBA's transparency exercise and the EBA's 2016 disclosure guidelines endeavour to align disclosure requirements with regulatory reporting requirements where possible.

In the United States, regulators go a step further by requiring public disclosure of regulatory returns in a central location. Banks are required to file a 'Call Report', which contain mostly financial data, and therefore share similarities with FINREP reporting. As a general rule, though, the Call Reports are less granular than FINREP. Information on regulatory capital is also required, but is duplicated in Basel Pillar 3 disclosures. Reports must be filed with the regulator at the close of business on the last day of each calendar quarter. The majority of these data are then publicly disclosed on the regulator's own website, subject to a time lag.

Disclosure of regulatory returns could be something that other jurisdictions might also consider in future. There are arguments for and against disclosing regulatory data.

Regulatory reporting data such as COREP, FINREP and the Solvency II Quantitative Reporting Templates include a wider range of information than is currently publicly disclosed through either banks' Pillar 3 reports or Solvency II's SFCR (see the box on page 198 for more detail). Therefore, making

(1) Bank of England (2016).
(2) European Insurance and Occupational Pensions Authority (2015).
(3) Insurance Authority (2014).

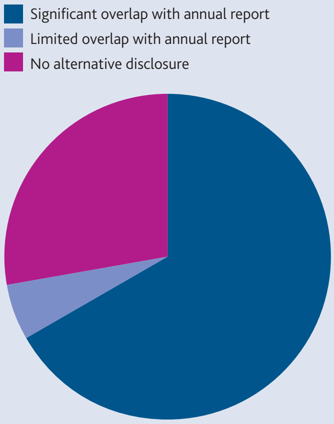
Regulatory returns and public disclosure — a cross-sectoral gap analysis

Our analysis compared existing disclosure requirements with regulatory returns. For banking this involved comparing FINREP returns with annual reports, and COREP returns with Pillar 3 reports, considering Phase 1 and 2 Basel disclosure standards. For Solvency II the Quantitative Reporting Templates (QRTs) required as part of insurers' private reporting obligations were compared with publicly disclosed returns. Each FINREP, COREP and Solvency II template was individually analysed to ascertain if the same or very similar data was publicly available. Each template was bucketed into the following categories:

- **Significant overlap.** For Solvency II this includes private templates which are published as part of the SFCR.
- **Limited overlap.** This includes examples where some of the data contained in reporting templates could be found in public disclosures, but where read-across was incomplete or some data points were missing.
- **No overlap.** Data found in private reporting templates had no correlative in public disclosures.

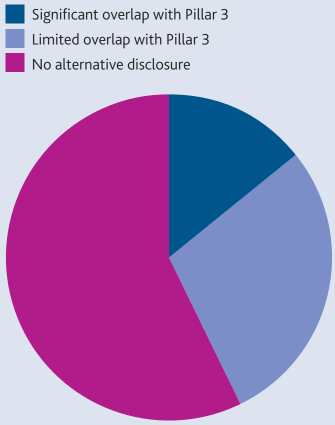
In the case of banks' FINREP returns around two thirds of the private reporting templates have significant overlap in scope with publicly available data in the annual report (**Chart A**), albeit often with a higher level of granularity.

Chart A Comparison of FINREP and annual report



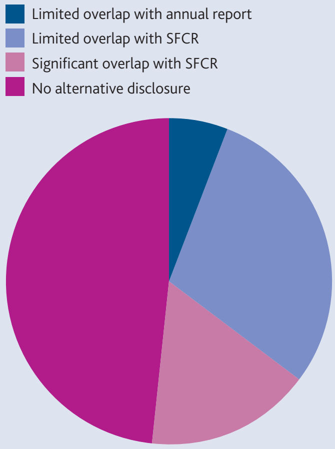
Substantial amounts of information contained in the COREP returns are not disclosed (**Chart B**). For many areas COREP contains a far greater breadth of metrics than Pillar 3 reports. These include IRB credit risk, counterparty credit risk and leverage. In other cases such as market risk there is an overlap in scope at the summary level between COREP and Pillar 3, but there is a far greater level of granularity available in COREP.

Chart B Comparison of COREP and Pillar 3 report



Analysis of the Solvency II returns, including the National Specific Templates, paints a similar picture (**Chart C**).

Chart C Comparison of Solvency II Quantitative Reporting Templates and SFCR/annual report



Private Solvency II regulatory returns include detailed information on investments and derivatives, reinsurance cover, annuity business, technical provisions and the impact of certain long-term guarantee measures. There is limited overlap with the annual report in valuation and measurement. A small proportion of QRTs are also disclosed alongside the SFCR.

regulatory returns public would not only greatly increase the volume of data available to market participants, but could also result in entirely new areas of data being disclosed. In addition, even in areas where information is publicly disclosed the corresponding private reporting templates collect data at a much greater level of granularity. Access to these could give market participants the ability to scrutinise firms in far more detail.

It is important to note, though, that it would not be appropriate to require disclosure of some of the data submitted by firms to the regulator. This is for a number of reasons: if data are confidential or proprietary then disclosure is likely to result in damage and costs to firms. Examples of such data include detailed information on large exposures or on the firm's business model. Moreover, the disclosure of some information that banks and insurers privately report could result in financial instability. An example of this is the premature disclosure of temporary use of central bank liquidity assistance. More generally, increased volume of disclosures does not inevitably lead to greater transparency and improved market discipline: data must be both usable and useful to the market.

With an eye to future work, potential new disclosures will need to meet certain criteria. The lists of principles governing disclosure requirements set out by Basel, EDTF and the IAIS (set out previously in this article) are a useful foundation. Similarly, the various disclosure initiatives acknowledge that there are some types of data where disclosures should not be required: where the data are confidential, proprietary or immaterial, or where there are risks to financial stability.

Working from this starting point could lead to a set of principles and exceptions that could be used to govern when disclosure of regulatory returns would be appropriate. Potential principles should ensure that disclosures are:

- **comprehensive and meaningful** — providing material insight into a firm's activities and risks, and prepared without unreasonable cost; and
- **comparable and consistent** over time and across firms, avoiding duplication.

Potential exceptions could include:
- **confidential**, **proprietary**, or **immaterial** information;
- information which, if published, could pose a **risk to financial stability**; and
- disclosures that inhibit **competition**.

That said, our gap analysis (see the box on page 198) also demonstrates that while there is a substantial amount of data contained in regulatory returns that is not disclosed, some privately reported data can be found in publicly available documents such as Pillar 3 and annual reports. Therefore simply disclosing any data which complies with principles and exclusions (such as those listed above) would result in unnecessary duplication of data. Instead, a possible solution would be to require only disclosure of compliant regulatory data which are not already available to the market in other formats.

Potential for future work: method of disclosures

As well as making sure that the right information is disclosed, regulators must also consider how to make these disclosures as useful as possible.

Location

The location of published disclosures is an important consideration. Currently both banks' Pillar 3 reports and insurers' SFCRs are published directly by firms on their own websites. By contrast, US Call Reports and the results of the EBA transparency exercise are examples of firm-level data being published in a central location.

Self-publication could enable firms to more easily provide context to help users to assess the firm's unique risk profile. However, a central database would make it easier for data users to analyse quantitative data across multiple firms, although it is important to ensure that definitions used for data are consistent and applicable across firms to avoid false comparisons. And there are fewer benefits in providing qualitative data via a central database.

For future disclosure initiatives, the choice of disclosure location will therefore depend on how these data will be used and the extent to which quantitative data relying on fixed definitions can give an accurate picture of individual firms without additional firm-specific context.

Data format

The format in which disclosures are published is another significant question. If firms' disclosures are machine-readable — published, for example, in XBRL — they can be easily converted by users into a variety of formats. This would make comparing different firms' data much simpler, and could greatly expand the ways in which disclosures are analysed by investors. Publishing in a common format would therefore allow users to aggregate data without the need for the disclosures to be published in a central location. Of course, XBRL capability comes at a cost, so providing disclosures in a variety of formats would cater for a wide spectrum of potential users.

Data assurance

Simply releasing a greater quantity of information to the market is not necessarily beneficial of itself. Users must be confident that the data are reliable before they use them to inform investment decisions. To that end, the revised Basel Pillar 3 requirements state that banks must establish a formal board-approved disclosure policy for Pillar 3 information. At least one senior officer of a bank must also attest in writing that Pillar 3 disclosures have been prepared in accordance with these board-agreed internal control processes. Solvency II includes similar data assurance requirements, and the PRA has made rules mandating the external audit of parts of the SFCR.

Research has shown that investors tend to use information from annual reports more often when they believe that the information has been audited.(1) Therefore expanding the external audit requirement to banks' Pillar 3 disclosures could improve the quality of published data, and increase market confidence in its reliability.

Conclusion

The number of disclosure initiatives post financial crisis demonstrates the importance of disclosure to a well-functioning financial system. Much progress has been made but regulatory gaps remain, owing in part to a lack of co-ordination. We have identified potential areas for progress, as continued development of disclosure is necessary to keep abreast of changes to the wider regulatory framework. Additionally, as we have noted throughout, there are costs and benefits associated with disclosure. As such, further cost-benefit analysis would be necessary before any new policies are pursued — especially as ongoing disclosure reforms such as Basel's Pillar 3 revisions continue to be implemented.(2)

(1) Arnold *et al* (2012).
(2) Any future work would need to consider interactions with other regulatory disclosure requirements, such as those relating to inside information as set out in the EU by the Market Abuse Regulation (MAR). This article should not be taken to have any bearing on disclosure obligations arising under MAR.

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