Working paper summary

Market discipline and Basel Pillar 3 reporting

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This paper provides an insight for regulators and market participants into the sharemarket impact of application of the Basel Pillar 3 bank risk reporting regime.

A marked difference is found to exist in the frequency of the bank risk reporting regime in Australia compared to Europe.

Furthermore, a significant difference is found to exist in the respective sharemarket responses to the risk reports of domestic and European banks. In addition, particular measures of risk are found to have greater sharemarket significance than others.

The aim of the recommended regulatory framework of the Basel Committee on Banking Supervision (BCBS) is to promote convergence in the regulation of capital measurement and standards for internationally active banks. The BCBS, or Basel, framework consists of the following three elements, or Pillars:

1. Guidelines for the measurement of eligible regulatory capital and risk-weighted assets;
2. Capital buffers for the interest-rate, credit and operational risks facing banks; and
3. Disclosure requirements that facilitate the assessment of capital levels, risk exposures and risk management mechanisms.

The Basel framework is recommended, as opposed to obligatory, and therefore countries may choose to implement the regulations in a manner that best fits their respective banking systems.

The study has two main goals:

1. To compare implementation of the Pillar 3 disclosure requirements across countries, in order to understand which regulations appear to work best; and
2. To examine whether the data contained in Pillar 3 reports serves as an effective mechanism for the maintenance of market discipline.

At a broad level, Pillar 3 reports provide an insight into the asset quality and credit exposure of banks. Specifically, they contain details regarding:

- Tier 1 Capital – the cumulative total of equity capital, retained earnings and disclosed reserves;
- Tier 2 Capital – comprising undisclosed reserves, revaluation and general loan-loss reserves, hybrid debt capital instruments and subordinated term debt;
- Risk-weighted assets – those that are assigned a pre-determined level of risk. This provides a common methodology to measure the riskiness of bank assets;
- Total credit exposure – the actual exposure to particular customers, industries and regions;

- Impaired assets – those that have experienced a loss event which will impact future cash flows;
- Past due – loans where repayments are more than 90 days past their due date.

The motivation behind Pillar 3 reporting is that adequate disclosure can reduce the level of information asymmetry between uninformed and informed traders. Such an outcome serves to reduce the cost of capital in primary markets, and can assist in the valuation of similar entities.

In the context of the banking sector, competitive considerations may underpin a reluctance to disclose information. However, it is argued that increased information disclosure by banks mitigates the broader economic risks that arise in the event of their failure. These risks include reduced output, higher unemployment, falling property prices and increased government debt.

The data sample for this study comprises 130 banks with assets of at least US$100 billion, spread across 33 countries. Significantly, a large disparity is evident in the frequency of Pillar 3 reporting in Europe compared to Australia. European banks generally produce one report per year, and publish it well after the release of their annual report. In contrast, Australian banks typically produce quarterly Pillar 3 reports.

The greater frequency of the Australian Pillar 3 reporting regime evidently captures the attention of the sharemarket, as share prices respond immediately following the publication of reports. In contrast, the share prices of European banks remain largely unmoved.

More specifically, Australian banks' stock prices are found to react positively to an increase in Tier 2 capital, but negatively to increases in impaired assets and total credit exposure. Interestingly, notwithstanding the stock price reaction to total credit exposure, a change in risk-weighted assets is found to elicit little response, indicating that the market largely discounts this measure.