THE DARK SIDE OF THE BASEL COMMITTEE'S PILLAR 3 FRAMEWORK[1]

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> "*Every disclosure scheme must have an articulated purpose, an identified mechanism through which it accomplishes that purpose, a design that takes into account the operation of that mechanism, and a careful analysis showing that the benefits of the system outweigh its cost.*"[2]

Introduction

You can tell by the title of my presentation that I will certainly not provide you with a balanced view on the Pillar 3 framework. Others before me have duly explained the merits of Pillar 3 and nobody disagrees with them. It cannot be disputed that banks must continue their efforts to be more transparent on their risk culture and the risk exposures that they are taking on board when conducting their business.

My presentation is, however, not about transparency. It is rather meant to bring under the spotlight a range of issues that also matter and which have remained in the shadow of the Pillar 3 debates for far too long.

The Basel Committee's framework on banks' risk disclosures is relatively recent. It was published in 2004 as a main component of Basel II. As you are aware, Basel II had revised the 1988 Basel Capital Accord with a view to better aligning the required regulatory capital with actual bank risk. Basel II was highly innovative because it went beyond setting minimal capital requirements for banks. It is divided into three pillars: the minimal capital requirements constitute the first pillar; the second pillar is the supervisory review process which adds a qualitative element to the quantitative minimum capital requirements; the third

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[1] The views expressed in this presentation are solely those of the author and may not, under any circumstance, be regarded as representing an official position of the European Banking Federation.

[2] Dalley, Paula J., *The Use and Misuse of Disclosure as a Regulatory System*, Florida University Law Review, Volume 34, Summer 2007, Number 4 - http://www.law.fsu.edu/journals/lawreview/downloads/344/Daley.pdf

pillar makes banks subject to enhanced disclosure requirements with a view of making use of the disciplining forces of the markets as a complement to the regulatory requirements.

Pillar 3 is in the process of being reviewed today. The review basically aims at promoting the comparability of risk data across banks to allow market participants to carry out peer analyses and benchmarking exercises. The emphasis is now on the disclosure of prudential key risk metrics that are comparable amongst banks and jurisdictions.

However, I will not elaborate on those technical changes which the Pillar 3 framework will be taken through. I will focus instead on the very roots of Pillar 3, i.e. the conceptual framework underlying it.

Two risk disclosure frameworks for banks

Before going into the heart of the matter, it needs to be highlighted that banks' risk disclosures are not only governed by the Pillar 3 framework. On top of that, banks also need to comply with risk disclosures imposed by the accounting framework, i.e. IFRS 7. Those risk disclosures fall under the scope of a conceptual framework which the International Accounting Standards Board has developed and which provides basic context to accounting numbers and disclosures. The IFRS Conceptual Framework is like a constitution providing the foundation of accounting standards and ensuring that standards are based on fundamental principles[3]. The IFRS Conceptual Framework is well documented.

Where Pillar 3 is concerned, a thorough and comprehensive document setting out its conceptual framework is, however, lacking.

To be honest though, the Basel Committee published already in 1998, soon after the Asian financial crisis, a report[4] prepared by one of its working parties which, in retrospect, has laid the ground for the Pillar 3 framework that Basel published a few years later. However, the world has moved on since then which makes that the 1998 report would probably benefit from receiving an update. The recent consultation on the Pillar 3 review[5] that Basel issued did, however, not undertake any attempt in that direction. As a result, no comprehensive document is available explaining to preparers and users of Pillar 3 disclosures how those disclosure requirements need to be put in context.

My presentation will start in making an attempt to fill in this gap in providing some clarity on the main building blocks of the Pillar 3 Conceptual Framework, which we believe to be as follows:

- Objective;

[3] Gore, Richard & Zimmerman, Dyan, *Building the Foundations of Financial Reporting: The Conceptual Framework*, The CPA Journal, Vol. 77, N° 8, August 2007.
[4] Transparency sub-group of the Basle Committee on Banking Supervision, *Enhancing Bank Transparency, Public disclosure and supervisory information that promote safety and soundness in banking systems*, September 1998 (http://www.bis.org/publ/bcbs41.pdf).
[5] *Review of the Pillar 3 disclosure requirements - consultative document*, June 2014. http://www.bis.org/publ/bcbs286.pdf

- Audience;
- Materiality;
- Proportionality;
- Protected information;
- Level of assurance.

1. Objective

The objective of the accounting disclosure framework is pretty clear, i.e. to provide information to users of financial statements and, more particularly, to provide them with information that may be of assistance to them when making economic decisions

The picture is quite different, however, where Pillar 3 disclosures are concerned. Obviously, Pillar 3 disclosures are also being imposed with a view to informing the markets and, in doing so, they definitely contribute to improving the decision making of investors. But that is only part of the story. The Pillar 3 framework is meant to achieve more as it is also aims at introducing market discipline.

What does this mean?

This is an easy question at first sight as the answer is rather obvious: Pillar 3 disclosures are being imposed because the information they reveal is expected to influence the behaviour of banks. Pillar 3 disclosures are intended to produce particular results as to the way in which banks manage risk. They are meant to encourage their management to establish sound risk management practices and contain excessive risk-taking behaviour.

This answer inevitably begs another question: how can disclosures succeed in changing the behaviour of banks?

To many observers the answer is simple. In their view, market discipline basically works through price and volume adjustments: whenever risk disclosures fail to inspire a satisfactory level of confidence, investors in equity or debt will react by imposing a higher price to compensate for the higher risk to which they are exposed or for their lack of sufficient knowledge. It is also possible that market participants will react upon the disclosures by modifying other transaction terms or by simply refusing to enter into new business with the bank.

We do not disagree with such an analysis, of course. The difficulty is, however that such an impact can probably not be seen as a specific feature of market discipline considering that financial reports have an identical impact. As we are all aware, shares of listed companies tend to move in one direction or another whenever financial results go public. This seems to indicate that the market discipline which Pillar 3 is striving for is not merely meant to operate through improving the price-setting function of the financial markets. There must be more to market discipline than just that.

What many are overlooking is that banks will not be sitting on a fence just waiting for the negative signals from disappointed market participants to come their way. They will try and react in a pro-active way in anticipating possible negative feedback. They will do their utmost to avoid revealing risk management practices that may be embarrassing and make sure to move into the desired direction[6].

To summarise: the objective of Pillar 3 is not so much to inform market participants but to act as a deterrent to banks. Pillar 3 basically relies on the presumption that, when they are aware that their behaviour is being monitored, banks will anticipate on market expectations by adapting their behaviour accordingly.

There is even more to market discipline – as I will explain in a few minutes. But allow me to make some basic critical comments on the market discipline concept first.

Firstly, it may be useful highlighting that the Pillar 3 framework is in general being looked at as a rather "soft" measure as opposed to the measures set out in the Pillar 1 framework. On the face of it, Pillar 3 has a limited impact as it merely requires banks to publish more data – full stop. However, as I have explained, it clearly is not an innocent measure as it may have a rather intrusive impact. It regulates conduct.

Secondly, it needs to be highlighted that, as many observers have commented, the concept of market discipline relies on the Efficient Markets Hypothesis and in particular on the basic assumption that market participants respond rationally to relevant information. One of the basic lessons we learned from the crisis is, however that market participants do not always react in a rational way[7]. They may be subject to the same errors or misperceptions as the banks being monitored[8]. Do we have to conclude that Pillar 3 has been built on quicksand?

Thirdly, even if we would go along with the Basel Committee and agree, for the sake of argument, that market participants tend to behave rationally, it must be added immediately that this does not necessarily mean that they will behave as one may expect. Various roads may be open to those who intend to behave in a rational way.

Experience gained in the past may illustrate this. It concerns disclosures on executive compensation which were stepped up in the US and Canada in the nineties of the previous century[9]. The expectation had been that investors would be outraged if they would learn about the high compensation packages that were being offered to executives and that, as a consequence, companies would anticipate such negative feedback by constraining executive

[6] In the words of the Basel Committee, quoted above, footnote n° 4," Enhanced public disclosure allows market discipline to work earlier and more effectively, thereby strengthening the incentives for banks to behave in a prudent and efficient manner. To the extent a bank's management knows its activities and risk exposures will be transparent, the various actions by market participants described in the preceding paragraphs, e.g., investment decisions and other business decisions, can provide a strong incentive for bank management to improve risk management practices and internal controls." (Paragraph 14).

[7] See in particular the critical comments made in this respect by:

- Davidoff, Steven M. & Hill, Claire A., *Limits of Disclosure*, 36 Seattle University Law Review 599 (2013); http://digitalcommons.law.seattleu.edu/sulr/vol36/iss2/11/
- Stephanou, Constantinos, *Rethinking Market Discipline in Banking*, Lessons from the Financial Crisis, World bank, Policy Research Working Paper, March 2010, page 9 http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-5227
- Avgouleas, Emilios, T*he Global Financial Crisis and the Disclosure Paradigm in European Financial regulation: The Case for Reform*, European Company and Financial law Review, Vol. 6, N° 4, 2009 - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1486302

[8] Llewellyn,David T. & Mayes, David G., *The role of market discipline in handling problem banks*, Bank of Finland Discussion papers 21 (2003), page 12 - https://ideas.repec.org/p/hhs/bofrdp/2003_021.htmlbn

[9] For more details, see Davidoff, Steven M. & Hill, Claire A., quoted above under footnote 7.

compensation. Unfortunately, this is not what happened. On the contrary even. Executives in the US and Canada took advantage of the disclosures to convince their board that they were less paid than their peers. As a result, executive compensation was not decreased; it appeared that their pay tended to be raised instead. This goes to show that rational expectations as to how disclosure may work may be totally wrong. Market reactions cannot always be predicted. The way in which people respond are sometimes not those one would expect based on economic theory.

The critical comments made above are meant to demonstrate that some safeguards may need to be put in place to make sure that regulators make the right choice as to the data which has to be disclosed. They must avoid that market discipline creates unpleasant surprises. One observer[10] has suggested, therefore, that, before issuing disclosure requirements, regulators should conduct experimental tests to examine how market participants react to them. He pointed out in this regard that IMF economists have been conducting such an experiment in the past using market professionals which has shown to be very useful to test theoretical assumptions.

2. Audience

Accounting standards are meant to serve the needs of investors, lenders and other creditors who use financial statements information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit. Accounting standard setters are aware, of course, that there are also other parties who will find financial statements undoubtedly very useful. The IFRS Conceptual Framework highlights, however, that accounting standards are not primarily meant to serve the information needs of regulators or other parties.

Pillar 3 disclosures, in contrast, are being imposed to serve the interests of “market participants”. This is obviously a much wider audience than merely current and potential investors and creditors. It includes uninsured depositors, information intermediaries such as rating agencies and financial analysts and, of course, also other banks.

What about the supervisory community itself? Obviously, Pillar 3 disclosures are of much value to them particularly if they allow them to make comparisons between the banks they supervise and those that are established in other countries which they do not supervise. However, Pillar 3 is intended to trigger market discipline. It has been developed having only market participants in mind. Banking supervisors cannot possibly be qualified as market participants.

This begs the question why banking supervisors are nevertheless so keen on determining themselves the risk disclosures that banks are required to make. Why don’t they simply delegate this work to market participants? Why don’t they just ask the banking industry to sit down together with market participants to come up with a set of disclosure templates?

[10] Avgouleas, Emilios, quoted above under footnote 7.

Part of the answer is the fact that regulators may wish to impose some specific disclosures to create awareness about the information itself in the hope that eventually market participants will start paying attention to the matter and influence choices made by a bank in this area[11].

I would like to illustrate this by drawing your attention to the issue of asset encumbrance disclosures. An excellent paper published by the European Systemic Risk Board (ESRB) perfectly explains why asset encumbrance is of a basic concern from a financial stability point of view[12]. The ESRB paper observes that reliance on collateralised funding has increased in recent years, particularly in Europe, due to a combination of a range of factors. It hastens to add that a recourse to secured funding is not an issue as such. However, there must be an appropriate balance between secured and unsecured funding, and such a balance is lacking today because creditors largely prefer relying on secured funding. This ought to change and the ESRB believes that increased disclosures on banks' asset encumbrance might provide a way out of the shift towards secured funding.

Question: how can enhanced disclosures about asset encumbrance help achieving a more appropriate balance between secured and unsecured funding? The ESRB answers this question in observing that more vulnerable banks tend to rely more heavily on secured funding. As a consequence – so their reasoning goes – disclosure can contribute to turning the tide: if banks provide more information about their asset encumbrance levels, it will become easier for market participants to identify those banks that have a better risk profile.

Clearly, however, market participants are likely to adopt a different perspective than macro-prudential regulators. The fact that secured funding is crowding out unsecured funding is probably of less relevance to them. The reason why they may be particularly interested in disclosures on asset encumbrance is that it is essential for lenders in a bail-in world to understand where they stand if the bank would become insolvent. Banks' creditors like to know if there will be sufficient unencumbered assets available to meet their claims if things go wrong. This means that they may be missing the point that the ESRB wished to make, i.e. that, as such, the level of asset encumbrance is an important indicator to assess the strength of a bank.

Fortunately, no harm is being done here as the noses of both the ESRB and the investor community are clearly pointing in the same direction: both are opposed to excessive asset encumbrance. However, there may be situations where the interests of both parties do not converge.

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[11] Smith, Matthew, *Disclosure-based Regulation*, Law & Economics Association of New Zealand Wellington Seminar, 20 May 2013page 6, under 2.9 http://www.google.be/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0CB8QFjAA&url=http%3A%2F%2Fchambers.co.nz%2Fwp-content%2Fuploads%2F2012%2F07%2FLEANZ-paper-Disclosure-based-regulation-200513.docx&ei=GPZtVPmEDojWPav9gbAP&usg=AFQjCNHkR36121QzEnGwepE8XQRLhAgD8A

[12] "*Annex to the Recommendations on funding of credit institutions*". http://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_2_annex.en.pdf?daf44a4b85a572a081f9a133a5ae31f2

This goes to show, again, that disclosure requirements may be misunderstood by the market and that, as a consequence, it is highly important for the regulatory community to duly explain what it intends to achieve with the disclosures that they are imposing[13].

3. Materiality

The concept of materiality is well understood where accounting disclosures are concerned. Under the IFRS Conceptual Framework, information is material whenever its omission or misstatement could influence the economic decisions that users make.

You are aware that the materiality principle is on the agenda of the IASB these days. The concern is not so much that the principle is being misunderstood and would therefore need additional clarification but rather that it is not being applied as it should. Many believe, more particularly that, preparers are too reluctant to 'filter out' information which is of no relevance which results in boiler plate disclosures and information overload.

Under the Pillar 3 framework, in contrast, regulators do not consider information overload as a major issue – which can probably be explained by the fact that Pillar 3 disclosures heavily rely on standardised templates which have the advantage of making it easier to search and process the information and easier to make comparisons across choices[14].

As to the meaning of the materiality concept, the Basel Committee seems to be fully aligned to the accounting definition, i.e. the user test[15].

It is interesting to note that Europe is front running the Basel Committee on this. Firstly, European legislation[16] has ring-fenced the principle of materiality in specifying that it does not apply to disclosures which are imposed in the area of corporate governance arrangements, the composition of own funds and remuneration policies. Secondly, the EBA is considering issuing guidelines which would impose heavy internal procedures on banks which boil down to discouraging them from making use of the materiality principle[17]. The consequence of the guidelines which it is proposing would be indeed that removing immaterial items would only be possible provided that preparers go through considerable extra effort in terms of planning, reviewing and considering potential cuts. This means that assessing materiality under Pillar 3 would become significantly more onerous than provided for under current financial reporting standards.

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[13] Dalley, Paula J., quoted above under footnote 2: "The fact that a disclosure scheme may appear less intrusive than traditional regulation should not excuse regulators from stating their goal, not least because the goal of a disclosure system will determine the mechanism by which it is likely to operate."

[14] Paredes, Troy A., *Blinded by the light: information overload and its consequences for securities regulation*, 81 Washington University Law review 417 (2003). http://openscholarship.wustl.edu/law_lawreview/vol81/iss2/7/

[15] See: Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, June 2006, Paragraph 817 (http://www.bis.org/publ/bcbs128.htm); Transparency sub-group of the Basle Committee on Banking Supervision (1998), quoted above under footnote 3, Paragraph 61.

[16] See Article 432, Paragraph 1, of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[17] See the Consultation Paper issued by the European Banking Authority entitled "*Consultation Paper on the draft guidelines on materiality, proprietary and confidentiality and on disclosure frequency under Articles 432 (1), 432 (2) and 433 of Regulation (EU) 575/2013*".

4. Proportionality

Both the IASB and the Basel Committee recognise that the principle of proportionality – i.e. the principle saying that disclosures need to be proportionate to the type or nature of an entity – should be taken into account.

The perspective of both standard setters is, however different. The IASB adopts a users' approach: disclosures need to be proportionate taking into account the needs of the users of those financial reports[18]. Basel, in contrast, seems to adopt primarily a preparers' view instead[19].

The recommendations which the Basel Committee has provided in the area of Pillar 3 disclosures for remuneration explicitly state that the national authorities should be authorised to make use of the principle of proportionality to determine the scope of application of its recommendations, i.e. by including thresholds of materiality or proportionality[20].

The European Banking Authority has made use of the principle of proportionality when developing its proposals on materiality[21] considering that they apply to significant institutions only.

5. Protected information

The IFRS Conceptual Framework does not elaborate on the disclosure of confidential data or of information that is legally protected because of the existence of professional secrecy obligations or because it is commercially sensitive. It is, however, undisputed that the IFRS framework authorises banks to restrain from disclosing proprietary and confidential information in such circumstances.

The Basel Committee agrees that protected information does not need to be disclosed. Its recent consultation paper on the pillar review has created some confusion, however, in stating that a balance need to be struck between the information needs of market participants with protecting the value to the bank of proprietary data[22]. This balancing requirement created some confusion in the minds of some who took away from it that there might be situations in which banks should disclose information notwithstanding that it is legally protected. This is probably a misunderstanding. What Basel probably meant to say was that, whenever legally

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[18] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/April/AP11-Disclosure%20Initiative-Principles%20of%20Disclosure.pdf

[19] Transparency sub-group of the Basle Committee on Banking Supervision (1998), quoted above under footnote 4, Paragraph 63: "The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and nature of a bank's operations". See also the Pillar 3 Review Consultation Paper, quoted above under footnote 5 which specifies in Paragraph 34 that "[t]he level of detail (…) should be proportionate to a bank's complexity."

[20] Basel Committee on Banking Supervision, Pillar 3 disclosure requirements for remuneration, July 2011, at Paragraph 7 -http://www.bis.org/publ/bcbs197.pdf

[21] Quoted above under footnote 17.

[22] See BCBS, *Review of the Pillar 3 disclosure requirements*, June 2014, Paragraph 36. See also: Transparency sub-group of the Basle Committee on Banking Supervision (1998), quoted above under footnote 4, Paragraph 23.

protected data is concerned, a bank does not need to disclose those specific items, but must disclose more general information about the subject matter of the requirement[23].

European legislation is more specific. It recognises that banks may omit information which is regarded as proprietary or confidential, except for the disclosures on the composition of own funds and remuneration policies[24].

The European Banking Authority has proposed an even more stringent approach[25].

Firstly, it takes the view, that, where proprietary information is concerned, it may be omitted only if its "disclosure might drastically impact the institution forthcoming results or fundamentally negatively affect the institution competitive position" and institutions are expected to identify specifically to what extent the disclosure of information would weaken their competitiveness and document the impact of disclosure.

Secondly, where confidential information is concerned, banks may only refuse to disclose the data provided that they come up with a legal analysis of the incidence of disclosure on the rights of their customers or counterparties or respect of legally established confidentiality obligations.

6. Level of assurance

IFRS 7 disclosures need to be examined by an external auditor. The situation is different where Pillar 3 disclosures are concerned: they are not required to be audited[26].

The Pillar 3 review consultation paper takes the view that Pillar 3 information should be subject, at a minimum, to the same level of internal review and internal control processes as the information provided by banks within the management discussion and analysis.[27]

How to make two frameworks meet?

Let's try and draw some conclusions from the overview that we provided.

To start with: we are all aware that the accounting perspective is basically different from the regulatory view. Both frameworks are largely unrelated and independent. They use measurements methods which are different; the consolidation circles are not aligned either which makes that a banking group which is being referred to in the financial reports is not the

[23] See: Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, June 2006, Paragraph 819.
[24] See Article 432, Paragraph 2, of Regulation (EU) No 575/2013.
[25] See its Consultation paper quoted above under footnote 17.
[26] See: Basel Committee on Banking Supervision, Basel II, quoted above under footnote 15, 2006, Paragraph 816.
[27] See Paragraph 28.

same as to the banking group which regulators have in mind. The netting rules are different, etc.

Secondly, as explained, there are also huge differences between the conceptual framework governing both types of disclosures. Their very objective – information versus market discipline – is basically different. On top of that, they are directed towards a different audience - which makes matters even more complicated.

Finally, you will have noted that regulators, particularly those in Europe, seem determined to make sure that both worlds even move further apart where the principles of materiality, the principle of proportionality and protected information are concerned.

Clearly, we are being faced here with two different worlds.

At the same time, however, everybody agrees that financial statements and Pillar 3 reports are not incompatible. On the contrary even, as, to a certain extent, both frameworks have similar goals considering that they are meant to contribute to a better understanding of the way in which banks manage their risk. Even if both data sets provide information that may not be easy to reconcile, they are deemed to complement each other and to contribute to achieving a more comprehensive view on the way in which banks manage risk.

This bring us to the key question: how can we see to it that both frameworks meet each other?

There are two opposing views circulating.

The regulatory community believes that the proper way forward should be to recognise that Pillar 3 will become the one and only benchmark in the area of risk disclosures[28]. It concedes that it is of paramount importance to avoid Pillar 3 from entering into conflict with requirements under accounting standards[29]. It also agrees that both frameworks should meet somewhere and believes that this should be organised by building bridges between Pillar 3 data and the financial statements. However, ensuring consistency with IFRS 7 disclosure requirements is definitely not a major priority to them[30] .

On the other side you have those who emphasise that the divide which the regulatory community is creating between IFRS and Pillar 3 disclosures is artificial and, moreover, that presenting different views of the same type of information may be highly confusing. Their basic view is that the main objective of risk disclosures should be to serve the information needs of the investor community and that all other considerations should be regarded as secondary[31]. Investors look at a firm overall, and want as much coherence as possible Furthermore, they do not support creating structures and processes for regulatory disclosure which are distinct from those in place for financial accounting disclosures. In other words,

[28] Representatives of the Basel Committee's Working Group on Disclosure stated at an Outreach Meeting held in London on 14 October 2013 that they would wish Pillar 3 disclosures to become the document of first choice in the future.

[29] See: Basel Committee on Banking Supervision, Basel II, quoted above under footnote 15, 2006, Paragraph 813; BCBS, Review of the Pillar 3 disclosure requirements, June 2014, Paragraph 18.

[30] See the criticism made in the IIF –ISDA – EFMA comment letter on the Pillar 3 Review consultation highlighting that it proposes a number of risk disclosures that are quite similar to existing disclosures in financial statements, yet with regulatory definitions applied. http://www.bis.org/publ/bcbs286/iifisdagfma.pdf

[31] See in particular the HSBC comment letter on the Pillar 3 Review consultation - http://www.bis.org/publ/bcbs286/hsbc.pdf

both frameworks should make identical use of the principles of materiality and proportionality, etc.

Who's right and who's wrong? As always, the right answer is probably somewhere in the middle.

The regulatory community needs to accept that market discipline can only work effectively provided that those market participants who really do matter – that is to say investors - believe it to be worthwhile going through the effort of taking a close look at Pillar 3 disclosures. Today, investors tend to include regulatory disclosures into their analysis because they can contribute to a better understanding of financial statements and also, and foremost, to obtain a better view on what may happen when things go wrong. Regulators should become more comprehensive to their information needs.

This means that it cannot be sufficient for regulators to focus on avoiding a clash between the accounting and the regulatory view. The bar needs to be put at a much higher level: both frameworks should not merely co-exist but be designed in such a way that they present a suitable overall package.

It should also be clear, however, that the regulatory view on risk has merits in its own right. As a consequence, investors should become aware that Pillar 3 disclosures are not merely around to satisfy the information needs of investor community. Pillar 3 is about market discipline, which is a different story altogether. Investors need to be prepared to go through a learning process and achieve an understanding of the added value that regulatory risk disclosures can provide in their own right.

To summarise: both parties need to be prepared to compromise.

The best way forward, therefore, seems to be for accounting standard setters and regulators to sit together and collaborate closely with each other to achieve a fully integrated and efficient overall disclosure package that would introduce market discipline and that would also serve the needs of the users' community and work better for preparers. It is worthwhile highlighting in this regard that the IASB intends to review its disclosure principles in a near future and has indicated that it stand ready to coordinate its efforts with those of regulators in the field of disclosures.

Ideally, other stakeholders would need to be brought around the table as well. Users, in particular, can benefit from such an exercise to make sure that they gain an appropriate understanding of what the disclosure packages aim to achieve. It would also be useful to involve preparers of risk disclosures considering that they need to be given an opportunity to highlight, where needed, the merits of specific data items adopting a cost/benefit perspective.

Welcome to our disciplinary society!

You may recall that I started my presentation in highlighting that many others before me have been praising transparency and the benefits that Pillar 3 disclosures can bring in this regard.

Where transparency is concerned, one contribution that I would like to recommend in particular is a speech entitled “Transparency and Democracy”. which the former President of the European Central Bank, Mr Jean-Claude Trichet delivered two years ago in front of the French *Académie des Sciences Morales et Politiques*. It is, unfortunately, available in French only[32]. His speech explains in particular why it is so crucial in our democratic societies for governments and public authorities – such as the Basel Committee, I presume - to be fully transparent. Moreover, Mr Trichet puts us on guard against the threats that transparency may involve to our democratic societies by making an extensive reference to a book entitled “Discipline and Punish” that a fellow countryman of him, Michel Foucault, published in 1976.

Michel Foucault (1926-1984) was one of the most influential French philosophers of the second half of the previous century. He was not only a subversive author but also a political activist who stood up for all those who are being excluded by civil society and, in particular, for prisoners and those who are locked up in mental institutions. One of his main drivers was to highlight the human cost of exclusion, incarceration and surveillance. His book is directly relevant to us because his provocative analysis provides a sobering perspective on the very concept of market discipline.

One of the basic themes which haunted Michel Foucault throughout his life was the concept of power and the way in which power operates in society. The main merit of his research has been to put basically into question the way in which we look at power. When we reflect on power, we far too often tend to have in mind the position that Kings had during the Middle Ages. In those days, power was clearly visible: it was vested in the king (and the court circle). In modern societies, however, power has become less visible. Today’s power has become dispersed and basically aims at putting in motion a machinery which mobilises society as a whole. Market discipline as referred to in the Pillar 3 framework is a perfect example: the surveillance which we are talking about here is not being exercised by public authorities but by market participants, that is to say: by you and me.

Power’s main tool to control its subjects is compulsory visibility. It calls for transparency. As I just explained, power may have become less visible today. It is now the subject who has to be seen. To achieve visibility, the primary focus is on measurement: everything is being reduced to numbers. Furthermore, subjects are constantly involved in fields of documentation providing detailed numbers about the examination to which they are permanently made subject and which allows the Power machinery to control them in a most cost-effective way. Financial statements and other financial reports, asset quality review, stress testing exercises, Pillar 3 disclosures, etc. are perfect examples of what Foucault has in mind here.

Finally, and foremost, power has become more pervasive. Today’s society is not only interested in punishing those who have committed crimes but rather in intervening in a much more effective way than criminal law is able to achieve to organise society. The objective is now to reform the subjects and the various documentation processes which it establishes are meant to distinguish those that are within the norms and those who are not. The decisive criterion today is to know if your behaviour is normal or abnormal. When you are not behaving as one may expect normal people to do, you immediately become a suspect unless you succeed in talking your way out of it.

[32] See: http://seance-cinq-academies-2012.institut-de-france.fr/transparence-et-democratie.

Market discipline & the rule of law

It may be useful highlighting that the emergence of our disciplinary society is not a recent phenomenon. It became mainstream already towards the second half of the eighteenth century. This means that the advent of our disciplinary society coincides with the advent of the American and French Revolutions.

This is very strange and even surprising considering that, as you are aware, those revolutions introduced democracies which are founded on the rule of law. Under the rule of law, a basic distinction is being made between what is legal and what is illegal, between what is allowed and what is not allowed. The rule of law means that there should be no grey area in between because that may result in arbitrary decisions and judgments. . The law must be transparent and predictable and therefore, spell out how it excepts citizens and companies to behave. Clearly, this is quite a different approach when compared to the way in which our disciplinary society works. The main concern haunting our disciplinary society is not to distinguish between what is legal and what is illegal but to distinguish between what is "normal" and "abnormal" and to identify outliers.

At first sight, both approaches seem incompatible. And yet, our legal systems seem to have managed living with the tensions and frictions which both approaches may create. Satisfactory ways have been found to make sure that both approaches co-exist with each other. Modern legal systems contain possible excess which might flow from disciplinary mechanisms by providing citizens and companies with basic constitutional rights and freedoms.

This bring us immediately to one of the basic freedoms on which our modern democracies rely, i.e. freedom of speech. "Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas without interference by public authority and regardless of frontiers"[33]. Standing jurisprudence, both in the US and Europe, has confirmed that freedom of speech is not only meant to protect the free expression of political thoughts and that it covers commercial communications as well.

Clearly, disclosure requirements such as Pillar 3 aim to influence the way in which banks communicate with their clients and with the investor community in particular. Does this mean that they interfere with freedom of speech? US jurisprudence[34] appears to take as a starting point that the disclosure of purely factual and uncontroversial information which is meant to prevent deception of consumers, is not protected under the First Amendment. This means, for example, that accounting standard setters should not be worried: accounting disclosures are indeed typically purely factual and uncontroversial and, moreover, meant to serve the information needs of investors.

The situation is, however, different where Pillar 3 disclosures are concerned. As we have highlighted before, Pillar 3 disclosures are not merely meant to inform market participants but rather to introduce market discipline. This means that they cross a line: they are not merely

[33] Article 10 of the European Convention on Human Rights.

[34] See in particular Keighley, Jennifer M., *Can you handle the Truth? Compelled Commercial Speech and the First Amendment*, (June 18, 2012). University of Pennsylvania Journal of Constitutional Law, Forthcoming, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2086859

factual but also, and foremost, normative: the mandated disclosure reflects the legislator's belief about how a bank should behave. US jurisprudence seems to indicate that Pillar 3 requirements are protected under the First Amendment. We are not aware of any similar European jurisprudence on this matter[35] but we can imagine that European courts may be tempted to develop a similar line of reasoning.

This is not to say that Pillar 3 disclosure requirements would automatically be violating freedom of speech. However, because Pillar 3 disclosures are protected, the banking regulatory community is inevitably faced with some hurdles which it needs to overcome. Public authorities are only allowed to interfere with free speech provided that the formalities, conditions, restrictions or penalties which they impose are prescribed by law and that they are necessary in a democratic society[36].

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[35] For an overview, see Kreminska, Joanna, *Freedom of Commercial Speech in Europe*, 2005, aei.pitt.edu/3043/2/JKrzeminska_EUSA_paper.doc.

[36] As stated 00000000 in Article 10, Paragraph2, of the European Convention on Human Rights.