

### **How can regulations help to restore the confidence in the soundness of financial markets and institutions?**

In the wake of the financial market turmoil – which began in the U.S. subprime mortgage market in summer 2007 and rapidly spread to Europe – many reflections have emerged on how well our regulatory system is equipped to manage such events and a lot of good initiatives have been launched in order to prevent similar situations in the future.

We will not comment on all the suggestions for improvements which have been put forward in the ongoing discussions but concentrate on an issue related to financial transparency and hence the aim of improved market discipline: Disclosure of the result of institutions' individual capital assessment.

One of the triggers for the loss of trust in the banking system was a lack of information on which institutions have been hit and the scale of potential losses. Several initiatives aimed at enhancing transparency have been launched in this area. One aspect is the transparency about risk from exposures, although another aspect, maybe equally important, is the ability to absorb losses from these exposures.

With the implementation of the Basel II framework all institutions should have a process for assessing their overall capital adequacy in relation to their individual risk profile and a strategy for maintaining their capital levels, which in brief is called the Internal Capital Adequacy Assessment Process (ICAAP). A similar requirement is envisaged within the Solvency II framework, namely the Own Risk and Solvency Assessment (ORSA).

While the main purpose of the ICAAP is to enhance the link between an institution's risk profile, its risk management and risk mitigation systems and its capital in order to establish useful dialogues with its supervisor - we should also have in mind that the ICAAP is a forecasting tool of how much capital institutions should hold in relation to their risk profiles.

Hence we believe the results of the ICAAP are relevant for outside stakeholders. In this respect results include numbers as well as a summary of the deliberations.

Let us look at two banks (A & B) for illustrative purposes. Each of them has a capital adequacy ratio at 12.5 per cent. Let us assume that bank A has computed its ICAAP capital level at 9 per cent while bank B has computed its ICAAP capital level at 12 per cent. In the public the two banks might appear with equal capital strength, since they are reporting the same capital adequacy ratio and they show the same distance to the 8 per cent capital ratio threshold. Meanwhile the alarm bell might ring for supervisors for bank B that operates its activities close to the capital limits taking into consideration its overall risks. This implies a smaller effective capital buffer for bank B compared with bank A. Let us assume then that both banks are hit by subprime related loss with equal magnitude which implies that the capital adequacy ratio drops to 11.5 per cent for both banks. In this scenario investors are unaware that bank B operates with an ICAAP capital level of 12 per cent and that its capital buffer is now considered negative and therefore is considered in financial difficulties by supervisors. Investors in the example could not only be misguided to think that both banks operate with a substantial capital buffer. More importantly, the uncertainty about banks' capital buffer may also make investors less interested to invest in otherwise well capitalized banks.


Lack of comparability across financial institutions and complexity should not be an apology to refrain from disclosure of the result of institutions' individual capital assessment. We are already confronted with these issues today as an implication for IRB methods and the implicit discretionary assessments between banks.

We find that the current disclosure requirements under the accounting rules and pillar 3 might not address the situation with appropriate clarity. We suggest analysing further how more transparency of the results of the individual ICAAP to market participants can help to restore the confidence in the soundness of markets and institutions.

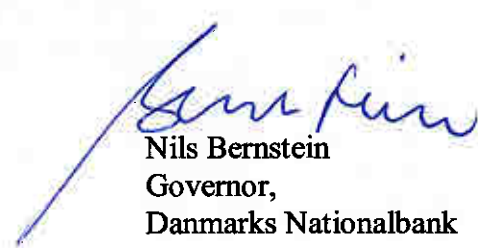
To sum up - under the present banking rules/accounting standards investors and other market participants are not necessarily equipped with the crucial information about the situation in banks, e.g.:

- How much capital does the management think is needed in relation to the activities of the company?
- And how does this assessment relate to the actual capital in the company?

We would find it to be a step forward, if we in the European legislation require financial institutions to disclose regularly the result of the ICAAP. In today's regime investors are unable to see whether a financial institution is well-capitalised or just appears to be.



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