BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Pillar 3

Presentation to the IBFed/IIF Pillar 3 Briefing for Analysts

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Outline

- Market Discipline
- The Role of Pillar 3 in Basel II
- Pillar 3 Disclosures
- What Pillar 3 will (and will not) provide
- Effective Implementation of Pillar 3
  - The role of supervisors, banks, and market analysts

What is market discipline?

- The ability of third-party claimants (eg debt and equity holders) to identify risk in financial institutions and to act in a way that signals those risks (to other market participants), or changes the behaviour of a financial institution.
- Two components of market discipline
  - Market monitoring
  - Market influence

The Role of Pillar 3 (market discipline) in Basel II

- Enhanced financial disclosures are another lever to strengthen the safety and soundness of the banking system

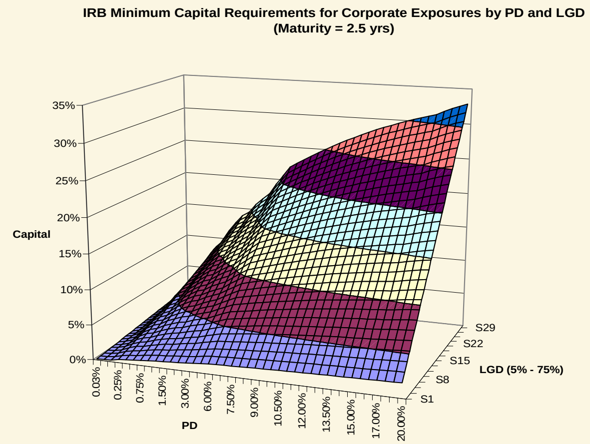
- Complements regulatory capital requirements (Pillar I) and the supervisory review process (Pillar II)
  - Note that Pillar 1 is NOT a full models-based approach
  - Supervisory conservatism is built-in

Pillar III Disclosures

- Disclosures consist of qualitative and quantitative information
- Pillar 3 should generally apply to the top consolidated level of the banking group
- Bank discretion to determine the appropriate medium and location of disclosures
- No need to duplicate other disclosure requirements
- Use test
- Materiality and Frequency
- Proprietary and Confidential Information

What Pillar 3 will (and will not) provide?

- Pillar 1 of Basel II is a much more risk-sensitive than Basel I



- Pillar 3 provides the market with substantially new quantitative and qualitative RISK information.

- Pillar 1 of Basel II places greater reliance on internal bank estimates of risk parameters (PD, LGD, EAD). Pillar 3 requires disclosure of these risk parameters.

What Pillar 3 will (and will not) provide?

- Don’t expect perfect consistency and comparability
  - Across banks?
  - Over time?
  - Across jurisdictions?
  - With accounting disclosures?

What Pillar 3 will (and will not) provide?

- Across banks there is likely to be diversity in
  - qualitative disclosures (related to risk management practices); and
  - quantitative disclosures (eg number of PD bands, granularity of industry and geographical distribution of exposures).
- Mix of qualitative and quantitative disclosure requirements in Pillar 3 seek to balance the trade-off between consistent and comparable information with institution-specific information.

What Pillar 3 will (and will not) provide?

- Headline capital ratio number needs to be analysed and understood within the context of:
  - Bank choices
  - Supervisory approaches (eg national discretions)
  - National environmental factors (eg legal and accounting rules)

- Pillar 3 will provide a clear improvement in disclosures and further improvements in the future.

Effective Implementation of Pillar 3 – Role of Supervisors

- Design of the overall framework
  - Specific changes when warranted
- Education and promotion of Basel II and Pillar 3
- Transparency of relevant supervisory approaches
- Promote consistency
- Monitor compliance

Effective Implementation of Pillar 3 – Role of Banks

- Provide information to promote transparency – not just about complying with minimum requirements.

- Promote understanding of their disclosures
  - Sufficient granularity
  - Key risk decisions and choices

Effective Implementation of Pillar 3 – Role of Analysts

- To benefit from better understanding the relationship between risk and returns for a given bank, and make comparisons across banks, requires:
  - Knowledge of Basel II and Pillar 3
  - Digging below the headline number
    - Environmental factors
    - Supervisory implementation differences
    - Individual bank decisions
  - A significant investment of time and effort

Conclusion

- Pillar 3 will provide much more detailed risk information
- Don’t expect perfect comparability
- Effective use of that information requires effort by analysts - for that there should be a reward
- This is an iterative and evolutionary process
- Supervisors have a role to play with regard to the overall architecture of Pillar 3 – but ongoing evolution should be largely driven by interaction between banks and analysts

The Basel Committee's Standards Implementation Group (S.I.G.)

- Last week the Basel Committee announced the creation of the SIG
  - Broadening the mandate of the AIG to include implementation of all Basel Committee standards and guidance, not just Basel II implementation
  - Basel II remains a top priority for the SIG (work on home-host issues; supervisory colleges; and the three Pillars of Basel II will continue)

The Basel Committee's Standards Implementation Group (S.I.G.)

- Financial crisis has demonstrated the need to follow-up on supervisory guidance and standards to promote consistent implementation by banks and supervisors
  - Eg Basel Committee guidance on stress testing, valuations, liquidity etc.
  - Addressing deficiencies in implementation just as important (if not more important) as addressing deficiencies in policies and practices.