A New Capital Adequacy Framework:

Pillar 3
Market Discipline

Consultative Paper

Basel Committee on Banking Supervision

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A New Capital Adequacy Framework: Pillar Three - market discipline

Executive summary

This paper provides detailed guidance on what disclosures should be made in order to advance the role of market discipline in promoting bank capital adequacy. It is designed to support and strengthen the third pillar of the consultative paper *A New Capital Adequacy Framework* issued by the Basel Committee in June 1999.

The issuance of this paper is a component of the Basel Committee's ongoing effort to promote enhanced transparency and effective market discipline worldwide. It is a key part of the Committee's attempt to enhance capital disclosures and seeks to elaborate on disclosures that should be made in order to advance the role of market discipline in promoting bank capital adequacy.

The recommendations in this paper fall into three areas: structure of capital, risk exposures and capital adequacy. The Basel Committee is firmly committed to improving public disclosure and market discipline, and invites comments on this paper on same timeframe as the consultation on *A New Capital Adequacy Framework* (i.e. by 31 March 2000).

As discussed in the consultative paper *A New Capital Adequacy Framework*, the focus of the new Framework and, consequently, of the third pillar will be on internationally active banks. However, the Framework's guiding principles, as embodied in the three pillars, are generally suitable for any bank in any jurisdiction, although full account should be taken of individual circumstances.

The Basel Committee recognises that the recommendations contained in this paper may need to be expanded on as debate on the consultative paper *A New Capital Adequacy Framework* develops and the actual new Framework itself is finalised.

1. General remarks

This paper, issued by the Basel Committee on Banking Supervision[1] (Basel Committee), presents disclosures in the areas of the structure of capital, risk exposures and capital adequacy that should be made by banking institutions in order to advance the role of market discipline in

[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Its current chairman is Mr William J McDonough, President of the Federal Reserve Bank of New York. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

promoting bank capital adequacy. It follows from the consultative paper *A New Capital Adequacy Framework* issued by the Basel Committee in June 1999 and specifically provides additional information to support and extend the third pillar of the paper 'Market Discipline'.

Pillar three builds on concepts developed in the Basel Committee's report on *Enhancing Bank Transparency*[2], which discusses the role of transparency and disclosure of information in strengthening market discipline and effective banking supervision. In addition, the Basel Committee has recently issued *Sound Practices for Loan Accounting and Disclosure, Recommendations for Public Disclosures of Trading and Derivatives Activities of Banks* and *Best Practices for Credit Risk Disclosure*. This paper provides more detailed guidance in the areas of the structure of capital, risk exposures and capital adequacy.

The Basel Committee has sought to identify gaps in current disclosure practices in the areas of the structure of capital, risk exposures and capital adequacy. To this end, it has conducted a number of fact-finding surveys, including interviews with a wide range of information users (e.g., rating agencies and market analysts) and surveys of actual disclosure practices in various countries. The results demonstrate that there is a clear demand for greater and more detailed information in these areas and that there are significant gaps in the information disclosed currently.

The publication of this paper reflects an effort by the Basel Committee to fill those gaps by encouraging disclosures that provide increased transparency and comparability.

The Basel Committee acknowledges that the extent of current disclosure practices differs between its member countries and that some of the recommendations contained in this paper are already in force in some jurisdictions. However, the Basel Committee feels that it is important that the role of market discipline in promoting bank capital adequacy be advanced and encouraged within member countries in order to enhance the role that the market can play in ensuring that banks hold an adequate capital level.

Section 2 of this paper discusses the rationale for enhanced capital disclosures and looks at potential future guidance that might be considered by the Basel Committee. Section 3 provides detailed disclosure guidance in the areas of the structure of capital, risk exposures and capital adequacy.

2. Rationale for Enhanced Capital Disclosures

The Basel Committee acknowledges that progress has been made on enhancing transparency and promoting market discipline through a number of international and national initiatives. Pillar three of *A New Capital Adequacy Framework* is intended to take this further and to provide banking institution specific guidance in the important area of capital; in addition to promoting safety and soundness in banks and financial systems this will support and enhance

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[2] This report discusses the role of disclosure and transparency in fostering safe and sound banking systems and presents general guidance on public disclosure and supervisory information needs. It was issued by the Basel Committee in September 1998.

both pillars one and two of the draft framework by enabling the market to make an informed assessment of a bank’s overall capital adequacy position.

The Basel Committee does not view the three pillars discussed in *A New Capital Adequacy Framework* and any supporting papers as being separate initiatives but rather as being complementary parts of a general attempt to enhance the international capital adequacy framework and to improve its overall effectiveness and operation. The issues discussed in this paper and the recommendations included should be viewed in this context.

All of the recommendations contained in this paper are important and highly relevant. However, the Basel Committee acknowledges that further disclosure recommendations may need to be made, especially once the outcome of the debate concerning the other parts of the capital accord framework is known.

Enhancing Bank Transparency sets out the Basel Committee’s thoughts on the importance of transparency and the role that increased disclosure can play in complementing supervisory efforts. The consultative document *A New Capital Adequacy Framework* builds on this and discusses the importance of transparency in the context of a bank’s capital.

Market discipline performs an essential role in ensuring that the capital of banking institutions is maintained at adequate levels. Effective public disclosure enhances market discipline and allows market participants to assess a bank’s capital adequacy and can provide strong incentives to banks to conduct their business in a safe, sound and efficient manner.

Public disclosure about the nature, components and features of capital provides market participants with important information about a bank's ability to absorb financial losses. When they are a significant proportion of a bank's capital, it is important that innovative, complex, and hybrid capital instruments are adequately disclosed, since the characteristics of such instruments may have a significant impact on the market's assessment of the strength and integrity of a bank's capital.

Information on a bank's level and composition of capital should be augmented with meaningful disclosure of its risk exposures. A bank's risk profile, that is, the risks inherent in its on- and off-balance-sheet activities at a point in time and its appetite for taking risk, provides information about the stability of an institution's financial position and the sensitivity of its earnings potential to changes in market conditions.

Given the dynamic financial markets in which banks operate, and the influences of increased global competition and innovation, a bank's risk profile can change very quickly. Therefore, users of financial information need measures of risk that remain meaningful over time and which accurately reflect sensitivities to changes in underlying market conditions.

The Basel Committee strongly supports the concept of transparency. The Committee views increased disclosure, enhanced transparency and market discipline as becoming an ever more important tool of supervision and would encourage all member countries to adopt the recommendations contained within this paper as soon as practicable.

3. Disclosure Guidance

The consultative paper *A New Capital Adequacy Framework* issued by the Basel Committee discusses the importance of reliable and timely information and the provision of such information. This section provides more specific guidance about public disclosures of capital structure, risk exposures and capital adequacy. Disclosures should be adapted to the size and nature of the institution's activities in accordance with the materiality concept. The recommended disclosures should be made *at least* annually and more frequently where appropriate.

Capital Structure

Recommendation 1

A bank should, at least annually and more frequently where possible and appropriate, publicly disclose summary information about:

(a) its capital structure and components of capital

A bank should disclose the amounts of its components and structure of capital based on the definitions contained within the Basel Capital Accord:

- the amount of tier one capital, with separate disclosure of:

  (i) paid-up share capital/common stock;

  (ii) perpetual non-cumulative preference shares;

  (iii) minority interests in the equity of subsidiaries;

  (iv) innovative or complex capital instruments[3] (e.g., minority interests that take the form of SPVs and tier one instruments with moderate step-ups), including the percentage of total tier one capital accounted for by such instruments;

- the amount of tier two capital (split between Upper and Lower tier two), with separate disclosure of material components;

- deductions from tier one and tier two capital;

- the amount of tier three capital;

- the total capital base.

[3] Please refer to the Basel Committee's press release of 27 October 1998

(b) the terms and conditions of the main features of capital instruments

A bank should disclose summary information about the terms and conditions of the main features of all capital instruments, especially in the case of innovative, complex or hybrid capital instruments.

Information disclosed should provide a clear picture of the loss-absorbing capacity of capital instruments and include any conditions that may affect the analysis of a bank's capital adequacy. This would include information on:

- maturity (including call features);
- level of seniority;
- step-up provisions;
- interest or dividend deferrals and any cumulative characteristics;
- use of Special Purpose Vehicles (SPVs);
- discussion of key 'trigger' events (i.e. events which may cause the activation of significant clauses or penalties which may affect the nature or cost of capital instruments);
- fair value and terms of derivatives embedded in hybrid capital instruments.

Recommendation 2

A bank should disclose information on its accounting policies for the valuation of assets and liabilities, provisioning and income recognition.

This information is important in an assessment of the quality and comparability of capital reserves that have been either generated through the income statement or recognised directly in equity. This disclosure could augment that envisaged in the Committee's paper *Sound Practices for Loan Accounting and Disclosure* and the Committee will consider where additional disclosure in this area might be appropriate.

Risk Exposures

Recommendation 3

A bank should publicly disclose qualitative and quantitative information about its risk exposures, including its strategies for managing risk.

In discussing each risk area, an institution should present sufficient qualitative (e.g., management strategies) and quantitative information (e.g., stress testing) to enable users to understand the nature and magnitude of these risk exposures. Further, comparative information of previous years' data should be provided to give the financial statement user a perspective on trends in the underlying exposures.

Credit Risk

Credit risk disclosures should enable the user to understand the extent and nature of an institution's credit exposure, both on an overall basis and in terms of significant components. These disclosures should also be sufficient to allow users to develop an understanding of how an institution manages credit risk and to what extent its strategies have been effective. The recommendations contained in the committee's papers, *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms* (which discusses quantitative and qualitative disclosures in the areas of market risk, credit risk, liquidity risk and other risks and quantitative disclosures in the area of earnings and qualitative disclosures in the area of accounting and valuation methods) and *Best Practices for Credit Risk Disclosure* (which discusses disclosures in the areas of accounting policies and practices, credit risk management, credit exposures, credit quality and earnings), set out the types of disclosures that banking institutions should seek to make with respect to risk exposures in this area.

Market Risk

As with credit risk, an institution should provide both quantitative and qualitative information regarding its market risk exposure. Recommendations on disclosures that are considered to be necessary in this area by the Basel Committee are discussed in *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*.

Operational, Legal and Other Risks

Risk exposures such as operational, legal and strategic risk can be difficult to quantify. However, they can be highly significant and relevant disclosures in these areas should be made. More detailed requirements for disclosures of operational risk factors may be required once the Basel Committee has published its proposed regulatory treatment of operational risk. In addition, banks should provide quantitative and qualitative disclosures on interest rate risk in the banking book.

Operational risk disclosures should include information about the main types of such risk and should identify and discuss any specific issues considered to be significant. Legal risk disclosures include legal contingencies (including pending legal actions) and a discussion of probable liabilities. Qualitative information about how the bank identifies, measures and manages these risks should be provided (i.e. methodologies used and organisational procedures), including the use of risk mitigation techniques.

Capital Adequacy Measures

Recommendation 4

(a) A bank should, at least annually, publicly disclose its capital ratio and other relevant information on its capital adequacy on a consolidated basis

To help market participants assess a bank's capital adequacy, it should at least annually disclose its risk-based capital ratio calculated in accordance with the methodology prescribed in the Basel Capital Accord as implemented by its home country supervisor, along with any other relevant information. Other relevant information might include future capital targets, although

confidential supervisory requirements would not be disclosed. This should also include information on the scope of consolidation for supervisory purposes.

(b) A bank should disclose measures of risk exposures calculated in accordance with the methodology set out in the Basel Capital Accord, as illustrated below

(i) Calculation of Basel Accord capital requirements for credit risk

- Balance sheet assets (specifying book value and risk weighted-amount for each risk bucket);
- Off-balance-sheet instruments (specifying nominal amount, credit equivalent amount and risk-weighted amount for each risk bucket);

(ii) Calculation of Basel Accord capital requirements for market risk.

a) Standardised approach (if appropriate)

Banks should disclose all information relevant to understanding how their Basel Accord capital requirement for market risk under the standardised approach has been calculated, including disclosure of capital charges for component risk elements, as appropriate.

b) Internal models approach (if appropriate);

Banks should provide all information relevant to understanding how their Basel Accord capital requirement for market risk under the internal models approach has been calculated. Disclosure of individual capital charges should be provided, as discussed in the disclosure guidance section on risk exposures. Information provided should be sufficient to allow understanding of the models used and should as a minimum include:

- Broad value-at-risk data;
- Parameters;
- Stress-testing information; and
- Back-testing information.

Recommendation 5

A bank should provide an analysis of factors impacting on its capital adequacy position. This would include:

(a) **changes in capital structure and the impact on key ratios[4] and overall capital position;**

(b) **its contingency planning, should it need to access the capital markets in times of stress;**

(c) **its capital management strategy and consideration of future capital plans (where appropriate);**

(d) **the impact of any non-deduction of participations in banks and other financial institutions, where applicable.**

Recommendation 6

A bank is encouraged to disclose its structure and process of allocating economic capital to its business activities.

Pillar two of the consultative paper *A New Capital Adequacy Framework* discusses the supervisory review and assessment of capital adequacy. It proposes that supervisors review a bank's capital position and strategy to ensure that it is consistent with its overall risk profile in order to enable early supervisory intervention if the capital strategy does not provide a sufficient buffer against the risk. The Basel Committee recommends that all banks have an internal process for assessing their capital adequacy and for setting appropriate levels of capital. This process should be objective and overseen by senior management and all banks should be able to demonstrate that the results of their internal processes are credible and reliable.

One method used by some banks is capital allocation. Capital allocation, the process of assigning economic capital to an institution's business activities, has become a useful tool for some banks in determining the adequacy of their capital and ensuring the efficient use of that capital. Specifically, capital allocation allows banks to compare the risk-adjusted profitability of diverse products and evaluate whether capital is sufficient on an individual business line basis as well as for the institution on an aggregate basis. They should also consider disclosing the amount of capital allocated to different transactions, products, customers, business lines, or organisational units (depending on the bank's methodology) so that information users may gain a better understanding of the risks and rewards inherent in the bank's activities. All banks should have a process to judge the adequacy of their own capital relative to their risks.

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[4] Particular ratios which should be considered will vary depending upon the circumstances of individual institutions and the specific changes in their capital structure. However, examples of relevant ratios which should be considered might include tier 2 capital /tier 1 capital, tier 1 capital/total capital and deductions form tier 1 and tier 2 capital/ total capital.