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Basel II – Pillar 3 Challenges for Banks

Risk and reward.
the right balance.*

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*connectedthinking

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Contents

IFRS 7 - Overview

- Effective for periods starting on or after 1/1/07
- Earlier adoption permitted
- Applies to all entities with financial instruments (not only derivatives)
- 'through the eyes of management' / internal information
- Disclose in financial statements or incorporate by (precise) cross reference from management commentary

Pillar 3 disclosures - Overview

- Improve market discipline through effective public disclosure
- Compliments requirements of Pillar 1 and 2
- Substantial new public disclosure requirements
  - Capital structure
  - Capital adequacy
  - Risk management
  - Risk measurement

Pillar 3 disclosures - Overview

- Qualitative and quantitative disclosures
- Significant components are prescriptive
- But judgement also required in places
- More complex firms - more disclosure

Pillar 3 disclosures - Overview

- By each separate category of risk – not limited to Pillar 1 risks
- Strategies and processes to manage risks
- Structure and organisation of risk management function
- Risk reporting and measurement systems
- Hedging and risk mitigation – strategies and processes

Pillar 3 v IFRS 7

Differences

• Pillar 3 broader than only financial instruments

• IFRS 7 also applies at subsidiary company level (and to only significant financial institution subsidiaries)

• IFRS 7 applies to risks arising from financial instruments – excludes operational risk?

• Pillar 3 does not apply to liquidity risk

• IFRS 7 requires risk disclosures by ‘class’ of financial instrument – Pillar 3 requires analysis by ‘exposure classes’ (types of claims)

• Definitions – eg past due and impairment (1 day v 90 days; incurred v expected)

Pillar 3 experience to date

- Some banks have already published
- For the majority, including most EU territories, calendar year end 2008 will be first time.
- Where should data be disclosed
  - Audited accounts
  - MDA
  - Web site
- Will look to cover the lessons learned from early adopters as well as those currently preparing to adopt.

Lessons Learned

The four areas identified are:

- Establish a strong governance process
- Address significant data and process challenges
- Devise and execute a coherent disclosure and communication strategy
- Embed an effective well controlled process into the organisation.

Lessons Learned

Establish a strong governance process:

- Major risk is lack of clear ownership
- Senior management sponsorship required (eg CFO)
- Ensure wide involvement of stakeholders (eg Board, Finance, Risk, IT, Audit and IR)
- Define clear responsibilities
- Implement strong project management processes

Lessons Learned

Address data and processing challenges

- Significant overlap with Pillar 1 (80%)
- Data quality issues around external disclosure
- Rigour and controls over data production
- Systematic approach for data goals
- Independent validation process
  - External audit – sometime mandated
  - Internal audit

Lessons Learned

Have a coherent disclosure and communication strategy

- Major strategic issue to consider
- Need consistency between
  - Pillar 3 and IFRS 7
  - Other risk management disclosures
  - Finance, Risk and IR communications
- Competitive advantage if able to present a clear and consistent communication message
- Experience shows this rarely happens

Lessons Learned

Embed an effective well controlled process

- Significant external business pressures
- Often viewed as a project and focus is 2008 disclosures
- Many projects behind schedule due to market events
- Cost pressure have lead to suboptimal solutions
- Hence often late and reactive solutions
- Need robust processes that are well controlled and replicable

What's next?

Additional requirements in the pipeline:

- Securitisations
- Sponsored SPEs
- Valuation techniques
- Revisions to IFRS 7

QUESTIONS?

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