



Discussion Paper

Implementation of the Basel II Capital Framework 7. Market disclosure

6 June 2007

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Introduction

The new Basel II capital adequacy regime, known as the Basel II Framework (the Framework), seeks to harness into the regulatory process best practices in risk management. By providing a spectrum of approaches to measuring capital adequacy of banks (and other authorised deposit-taking institutions (ADIs)), the Framework seeks to provide regulatory capital requirements that are both more comprehensive and more sensitive to risk and, as such, more closely aligned to the risk appetites of individual institutions.

The Framework will be implemented in Australia from 1 January 2008 through APRA's prudential standards.

The Framework is based on three mutually reinforcing pillars:

- new and considerably more sophisticated minimum capital requirements, including specific capital charges for operational risk (Pillar 1);
- institutions' own assessments of their capital adequacy and enhanced supervision of capital management (Pillar 2); and
- materially increased disclosure requirements (Pillar 3).

This discussion paper focuses on the proposed application in Australia of Pillar 3 (Market Discipline), which is intended to complement the other two Pillars by encouraging market discipline through disclosure that will enable market participants to assess the capital adequacy of ADIs. The disciplining effects of markets can reinforce prudential supervision by rewarding those institutions that assess and manage risk effectively and penalising those where risk assessment and risk management are inadequate.

Prudential standard

This discussion paper introduces a draft prudential standard *APS 330 Capital Adequacy: Market Disclosure* (APS 330) setting out minimum prudential disclosure requirements for locally incorporated ADIs. The standard recognises that, to be useful to a range of market participants, such disclosures should reflect the degree of sophistication applied by the ADI in managing risk, which in turn should reflect the scope and complexity of the ADI's operations. At the same time, ADIs should seek to ensure that all market participants can readily access

some basic information on ADIs' capital adequacy on a regular basis. The requirements of the prudential standard have therefore been tailored to the two broad approaches that will be taken by ADIs to measuring their capital adequacy for regulatory purposes under the Framework.

The key requirements of the prudential standard are:

- locally incorporated ADIs that are Australian owned and have been accredited by APRA to use the more advanced Basel II approaches are required to make extensive disclosures of both quantitative information (semi annually) and qualitative information (annually), in addition to the disclosure of a basic set of information on their capital adequacy (quarterly);
- locally incorporated ADIs that are Australian owned and are using the standardised approaches are required to disclose the basic set of information on their capital adequacy on a quarterly basis; and
- locally incorporated ADIs that are foreign owned are required to disclose the basic set of information on a quarterly basis, although APRA may, on a case-by-case basis, require such an ADI to make more extensive disclosures on its capital adequacy.

In addition, APRA may vary the disclosure requirements for an ADI depending on its particular circumstances. APRA may also require an independent audit of an ADI's prudential disclosures made under the standard.

The draft APS 330 is available on APRA's website at www.apra.gov.au. Written submissions on the draft standard should be forwarded by 13 July 2007 to:

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Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

Prudential issues surrounding APS 330

The Basel Committee on Banking Supervision (the Basel Committee) has stated that the rationale for Pillar 3 is sufficiently strong to warrant the introduction of extensive disclosure requirements on internationally active banks. The Framework is dedicated to the international convergence of capital measurement and standards and, in APRA's view, there would need to be very strong reasons not to embrace this key element in Australia. Indeed, with few exceptions, Pillar 3 disclosure will be mandated by APRA's overseas counterparts. Further, to enhance the comparability and therefore usefulness of Basel II information, a consistent and understandable disclosure framework is needed, and Pillar 3 aims to provide this. The complexity of the information generated by ADIs using the more advanced Basel II approaches also means that detailed requirements are unavoidable.

However, while there are good reasons to require the larger, more complex and internationally active ADIs using the more advanced approaches to make the full and detailed disclosure proposed under the Framework, it is less clear that such extensive disclosure requirements are appropriate for other ADIs. For the smaller ADIs in particular, the requirements could add to costs with uncertain benefit in terms of market discipline.

At the same time, APRA observes that current prudential disclosure practices among the small to medium-sized ADIs appear to vary considerably. In some instances, the capital adequacy of the ADI can be difficult, if not impossible, to discern. Hence, APRA sees benefit in all ADIs making at least some basic level of disclosure of their capital adequacy.

APRA therefore proposes to mandate Pillar 3 disclosure for all locally incorporated ADIs in Australia, with minimum requirements to be set out in a prudential standard.¹ For a locally incorporated ADI that is Australian owned and is using the more advanced Basel II approaches, the requirements involve full and detailed disclosure broadly consistent with the Pillar 3 proposals under the Framework.

For all other ADIs, including foreign-owned subsidiaries, a limited set of (quantitative only) disclosure requirements relating to capital structure, capital adequacy and credit risk exposure is proposed. ADIs are already generating this information as part of their normal prudential reporting to APRA, so compliance costs should be minimal. Some of this latter group of ADIs may decide to make fuller Pillar 3 disclosures anyway as a result of market pressure or simply because they see net benefits in doing so. This seems likely in the case of the larger Australian-owned ADIs, including those that may seek approval to use the more advanced Basel II approaches subsequent to 1 January 2008, and some of the larger foreign-owned subsidiaries, which compete across a broad range of activities/markets.

APRA has taken a pragmatic approach to the introduction of Pillar 3 disclosure requirements for ADIs. In particular, it has looked to minimise the reporting burden on the smaller ADIs, while at the same time seeking to meet both the market's demand for such information and APRA's responsibilities as a supervisor of internationally active banks. APRA encourages each ADI to ensure that its prudential disclosures are sufficiently detailed to assist market participants in making informed judgements about the institution's capital adequacy and approach to risk management.

APRA welcomes comments on its proposals, as reflected in the draft APS 330, particularly in relation to the matters mentioned below.

Disclosures by foreign-owned ADIs

Consistent with the Framework, APRA is not proposing that locally incorporated ADIs that are foreign owned make regular detailed disclosures of their capital adequacy and approach to risk management separate to those of their overseas parents. Nevertheless, APRA sees value in such ADIs disclosing the same basic set of (quantitative) information as Australian-owned ADIs, on a quarterly basis. Since foreign-owned ADIs raise deposits in Australia, this disclosure is consistent with APRA's 'depositor protection' responsibilities. It will also add little to costs, since such ADIs are already generating the information as part of their normal prudential reporting to APRA.

¹ Branches of foreign banks are not separately subject to the Framework (but, of course, for capital adequacy purposes, they are captured as part of the foreign bank in its home jurisdiction).

At the same time – and, again, consistent with the Framework – APRA can require a foreign-owned ADI that has APRA's approval to use the more advanced Basel II approaches to increase the content and/or frequency of its prudential disclosures beyond the basic levels required under Part B of the standard.

More generally, under the standard APRA can vary the minimum disclosure requirements applying to an individual ADI, including a foreign-owned ADI, depending on its particular circumstances.

Order/layout of disclosures

To allow readers to make ready comparisons across institutions and time, APRA is proposing that ADIs adhere to the order/layout of the prudential disclosures as set out in Attachments A and B to the standard. The order/layout reflects requirements proposed by the Framework.

Medium/location of disclosures

APRA's requirements may mean that certain items of information will be replicated by an ADI, possibly across several public mediums/locations. Nevertheless, consistent with the Framework, APRA sees benefit in readers being able to readily access an ADI's full prudential disclosures in at least one location. APRA is proposing that this location be the ADI's website.

If an ADI does not currently have its own website, APRA will consider alternative default locations for that ADI's prudential disclosures.

ADIs will not, of course, be precluded from publishing their prudential disclosures, in part or full, in other mediums/locations (e.g. annual reports).

Proprietary and confidential information

The Basel Committee believes the Pillar 3 requirements strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information. Nevertheless, it recognises that, in exceptional circumstances, the disclosure of certain items of information under Pillar 3 requirements may prejudice the position of the institution by making public information that is either proprietary or confidential in nature.

For its part, APRA has built into the draft prudential standard a provision for an ADI not to disclose such information in specific instances. However, APRA would prefer to clarify with ADIs any more general issues they may have with the proposed content of prudential disclosures under the standard, particularly in terms of the protection of proprietary information, ahead of the commencement of the new requirements on 1 January 2008.



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