SOUTH INDIAN Bank

STUDENTS' ECONOMIC FORUM

To kindle interest in economic affairs...
To empower the student community...

www.sib.co.in

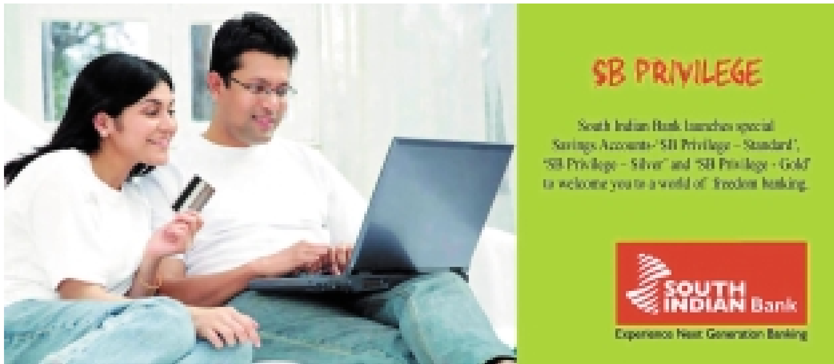
ho2099@sib.co.in

February 2008

Theme 195
BASEL II - PILLAR 2 & 3

A monthly publication from South Indian Bank

17th Year of Publication



South Indian Bank has launched **'SB Privilege'**, the value-added Any Branch Banking(ABB) Savings Account. Have a look at the salient features of these **Next Generation Banking** products!

SB Privilege Accounts	Standard	Silver	Gold
Monthly Average Min. Balance	Rs.1,000	Rs.5,000	Rs.10,000
And Enjoy the Freebie Banking Facilities			
ABB Cash withdrawal per day	Rs.10,000	Rs.20,000	Rs.50,000
ABB Cash Remittance per month	Rs.50,000	Rs.1lac	Rs.2 lac
ABB Clearing/Transfer per month	Rs.50,000	Rs. 1 lac	Rs.2 lac
RTGS/NEFT per month	Rs.50,000	Rs.1 lac	Rs.2 lac
DD/PO Purchase per month	Rs.10,000	Rs.50,000	Rs.1 lac

- 25 nos. of At Par Payable Cheque leaves per year - Free of cost
- Internet Banking - With Free Fund Transfer facilities
- ATM cum Debit Card - Free Fund Transfer & No Annual fee
- Silver & Gold account holders can **withdraw cash through other bank's ATMs in India, FREE OF CHARGE !**

For further details please log on to **www.sib.co.in**

SOUTH INDIAN Bank
Experience Next Generation Banking
The South Indian Bank Ltd., H.O. : 'S.I.B. House', Thrissur, Kerala

SIB STUDENTS' ECONOMIC FORUM

FEBRUARY 2008

Theme No. 195 : BASEL II – PILLAR 2 & 3

Introduction

One of the unique aspects of Basel II is its comprehensive approach to risk measurement in the banking entities, by adopting the now-familiar three-Pillar structure, which goes far beyond the first Basel Accord. To recapitulate, these are: Pillar 1 – the minimum capital ratio, Pillar 2 – the supervisory review process and Pillar 3 – the market discipline. The Pillar 1 provides a menu of alternative approaches, from simple to advanced ones, for determining the regulatory capital towards credit risk, market risk and operational risk, to cater to the wide diversity in the banking system across the world. Pillar 2 requires the banks to establish an Internal Capital Adequacy Assessment Process (ICAAP) to capture all the material risks, including those that are partly covered or not covered under the other two Pillars. The ICAAP of the banks is also required to be subject to a supervisory review by the supervisors. The Pillar 3 prescribes public disclosures of information on the affairs of the banks to enable effective market discipline on the banks' operations.

What are the RBI guidelines under Pillar-2?

The Pillar-2 of the framework deal with the "Supervisory Review Process" (SRP). The objective of the SRP is to ensure that the banks have adequate capital to support all materials risks in their business as also to encourage them to adopt sophisticated risk management techniques for monitoring and managing their risks. This, in turn, would require a well-defined internal assessment process within the banks through which they would determine the additional capital requirement for all material risks, internally, and would also be able to assure the RBI that adequate capital is actually held towards their all material risk exposures. The process of assurance could also involve an active dialogue between the bank and the RBI so that, when warranted, appropriate intervention could be made to either reduce the risk exposure of the bank or augment its capital.

Under Pillar-2, the banks have been advised to put in place an ICAAP, with the approval of the Board. Thus, ICAAP is an important component of the Supervisory Review Process. What is important to note here is that the Pillar 1 stipulates only the minimum capital ratio for the banks whereas the Pillar 2 provides for a bank-specific review by the supervisors to make an assessment whether all material risks are getting duly captured in the ICAAP of the bank. If the supervisor is not satisfied in this behalf, it might well choose to prescribe a higher capital ratio, as per its assessment.

What is ICAAP?

Pillar II envisages that

- Banks should establish adequate risk assessment processes
- The risk assessment processes should be specific to each individual bank and
- Each bank should develop and implement a comprehensive internal process for assessing its capital adequacy in relation to - its risk profiles as well as strategy for maintaining such capital levels.

ICAAP is expected to capture Residuary Risks such as

- Reputation Risk
- Liquidity Risk
- Credit Concentration Risk etc... which are not addressed by Pillar 1

These are to be captured apart from credit, Market and Operational Risks.

What is meant by risk based internal audit?

In view of New Basle Capital Accord, Reserve Bank of India has already decided to move towards Risk Based Supervision (RBS) in place of the present method of Annual financial Supervision of the Banks. For taking up RBS, Banks have been advised by RBI to adopt Risk Based Internal Audit.

A sound internal audit function plays a significant role in contributing to the effectiveness of the internal control system and should provide high quality counsel to management on the effectiveness of risk assessment and internal controls including regulatory compliance. Traditionally the internal inspection has been concentrating on transaction based, testing of accuracy and reliability of accounting, records and financial reports, integrity, reliability and timeliness of control reports and adherence to legal and regulatory requirements. The business of Banking has undergone a sea change and more activities are undertaken by the Banks today. So for

internal audit of Branches, transaction testing in itself will not be sufficient. So there is a need to re-orient internal audit function and focus on the specific risks on an on-going basis to evaluate the adequacy and effectiveness of internal control system and risk management procedures followed in the Banks. So in Risk Based Internal Audit, the role of internal auditors in mitigating risks gets more emphasis.

What is the purpose of Market discipline?

The purpose of Market discipline (Pillar 3) is to compliment the minimum capital requirements detailed under Pillar 1 and Pillar 2. The aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

In principle, banks' disclosures should be consistent with how senior management and the Board of directors assess and manage the risks of the bank. Under Pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. It is believed that providing disclosures that are based on a common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and comprehensive disclosure framework that enhances comparability.

What are the disclosure requirements under Pillar 3?

The requirements include both qualitative disclosures and quantitative disclosures in respect of scope of application, capital structure, capital adequacy, risk exposure and assessment, credit risk and its mitigation, securitization, market risk, operational risk, interest rate risk etc. It also includes terms of issue of innovative capital instruments in Indian rupee and foreign currency for Tier 1 capital, terms of issue of Tier 2 capital instruments in Indian rupees and foreign currency, issue of subordinated debt for raising lower Tier 2 capital, compliance with reserve requirements, reporting requirements, etc.

What is the scope and frequency of disclosures?

Banks should provide all Pillar 3 disclosures, both qualitative and quantitative, as at the end March each year along with the annual financial statements. With a view to enhance the ease of access to the Pillar 3

disclosures, banks may make their annual disclosures both in their annual reports as well as their respective web sites. Banks with capital funds of Rs.100 crore or more should make interim disclosures on the quantitative aspects, on a stand alone basis, on their respective websites as at end September each year. Qualitative disclosures that provide a general summary of a bank's risk management objectives and policies, reporting system and definitions may be published only on an annual basis.

In recognition of the increased risk sensitivity of the Revised Framework and the general trend towards more frequent reporting in capital markets, all banks with capital funds of Rs.500 crore or more, and their significant bank subsidiaries, must disclose their Tier 1 capital, total capital, total required capital and Tier 1 ratio and total capital adequacy ratio, on a quarterly basis on their respective websites.

The disclosure on the websites should be made in a web page titled "Basel II Disclosures" and the link to this page should be prominently provided on the home page of the bank's website. Each of these disclosures pertaining to a financial year should be available on the websites until disclosure of the third subsequent annual (March end) disclosure is made.

Are the disclosures required to be audited by an external auditor?
Pillar 3 disclosures are not required to be audited by an external auditor. But the disclosures should be subjected to adequate validation i.e. e. it must be consistent with the audited statements. If the information is published as a stand alone report or as a section of the website, the management should ensure that appropriate verification of the information takes place, in accordance with the general disclosure principles.

Whether the disclosures under Pillar 3 conflict with the accounting standards?
It is recognized that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The BCBS has taken considerable efforts to see that the narrower focus of Pillar 3, which is aimed at disclosure of bank capital adequacy, does not conflict with the broader accounting requirements. The Reserve Bank will consider future modifications to the Market Discipline disclosures as necessary in light of its ongoing monitoring of this area and industry developments.

Excerpts from the speech delivered by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the GARP 2008 9th Annual Risk Management Convention & Exhibition, New York, on 27th February 2008. For the full text of the speech please visit www.bis.org

"I am pleased to speak about the recent financial market turmoil and the concrete responses of the Basel Committee. The mission of the Basel Committee is to improve the quality of banking supervision worldwide and to promote strong risk management practices at banks. As you know, the trigger for the turbulence was sub-prime mortgage lending, much of which took place outside the regulated banking sector. A large part of this lending was based on weak underwriting standards.

From the perspective of bank supervisors, I believe there were three fundamental shortcomings that contributed to and amplified the turmoil. The first of these relates to the origination of credits. In many cases, firms neglected to define prudent firm-wide risk limits on these exposures. Second, risk management and measurement capabilities did not keep pace with rapid financial innovation and the evolution to market-based credit intermediation. Third, certain aspects of regulation, supervision and market transparency failed to reflect financial market developments and therefore contributed to weak practices at banks. These are areas where future practical improvements must be made.

From the Basel Committee's perspective, the previous analysis points to a number of concrete measures that banks and supervisors must take. I will address three of these initiatives the Committee is working to complete, which are:

- ***Implementation of and further improvements to Basel II;***
- ***Enhancing global standards for liquidity risk management and supervision; and***
- ***Strengthening other risk management practices, particularly with respect to stress testing and valuations.***

We have embarked on a focused and ambitious work agenda with clear deliverables. Some of the Committee's efforts will take time, but having a clear road map should improve market confidence even in the shorter term. And importantly, regulators need to make sure that the infrastructure of supervision, regulation and transparency keeps pace with innovation. I believe that the steps I have outlined will make the banking sector more resilient to the next set of shocks, whatever their source."

Experience Next Generation Banking

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur, Kerala 680 001 or by E.mail: ho2099@sib.co.in