RESERVE BANK OF MALAWI

GUIDELINES ON MARKET DISCLOSURES UNDER BASEL II DRAFT

Bank Supervision Department

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PART 1- PRELIMINARY

1. Mandate

These guidelines are issued pursuant to Section 96 of the Financial Services Act 2010 and implements the Directive on Disclosure of Information by Banking Institutions.

2. Objectives

The objectives of these guidelines are to:

(a) ensure that banks maintain a level of transparency that is relevant to enable bank stakeholders including potential and existing investors, depositors and the general public to make informed decisions.

(b) enhance market discipline in the banking sector by providing adequate financial information covering *inter-alia* financial performance, financial position, types of risk to which an entity is exposed, nature and extent of risk exposure and an overview of other key aspects

(c) promote and maintain public confidence in the Malawi banking industry through enhanced transparency.

3. Scope

These guidelines builds on the Directive on Disclosure of Information by Banking Institutions, to provide detailed guidance on the public disclosures of information by banks under Basel II Pillar 3 requirements .

4. Applicability

The disclosure requirements apply to all banks licensed under the Financial Services Act, 2010.

5. Abbreviations and Definitions

'A –IRBA' stands for Advanced Internal Ratings Based Approach.

'AMA' stands for Advanced Measurement Approaches.

'CAR' stands for Capital Adequacy Ratio.

'Credit Risk" is as defined in the Guidelines on Credit Risk.

'BIA' stands for Basic Indicator Approach.

'EAD' stands for Exposure at Default

'F-IRBA' stands for Foundation Internal Ratings Based Approach.

'Market risk' shall have the same meaning ascribed to that term in the Guidelines on Market Risk.

'Material information' Information is material if its omission or misstatement could change or influence the judgement or decision of a user relying on that information to take, among other things, economic or investment decision.

'Interest Rate Risk' shall have the same meaning ascribed to that term in the Risk Management Guidelines for Banks.

'Internal Ratings Based (IRBA) Approach' shall have the same meaning ascribed to that term in the Guidelines on Credit Risk.

"IRRBB" stands for Interest Rate Risk of the Banking Book.

'Liquidity Risk' shall have the same meaning ascribed to that term in the Risk Management Guidelines for Banks.

'Loss Given Default (LGD)' shall have the same meaning ascribed to that term in the Guidelines on Credit Risk.

'SA (CR)' stands for Standardised Approach – credit risk.

'SA (MR)' stands for Standardised Approach – market risk.

'SA (OR)' stands for Standardised Approach – Operational Risk

'**Operational Risk** shall have the same meaning ascribed to that term in the Guidelines for Operational Risk.

'PD' stands for Probability of Default.

PART II - GENERAL REQUIREMENTS

6. Frequency of disclosures

6.1. Any disclosure required under these Guidelines shall be made on a semi-annual basis, subject to the following exceptions:

(a) disclosures required under paragraph 10.1 and items that are marked as qualitative disclosures in Section 11 of these Guidelines shall be disclosed on an annual basis if there are no changes; and

(b) total CAR and Tier 1 CAR at the group level shall be disclosed on a quarterly basis.

7. Location and form of disclosures

7.1. Subject to paragraph 7.2 below, a bank shall disclose the information required under paragraph 10.1 and all other items in Section 11 of these Guidelines in its Annual Report and periodic financial statements.

7.2. A bank may disclose the items marked as quantitative disclosures in Section 11 of these Guidelines in an appropriate medium or location other than its Annual Report and periodic financial statements.

7.3. A bank must provide in its Annual Report and periodic financial statements clear references to the location of all disclosures required under these Guidelines.

7.4. A bank may exercise its discretion in determining the form of the disclosures required in these Guidelines, and may choose to use graphical and other representations where appropriate.

8. Omissions

8.1. A bank may omit certain disclosures in these Guidelines if:

(a) the omitted item is not material, in accordance with the concept of materiality under the Accounting Standards, or

(b) the omitted item is proprietary or confidential in nature and would seriously prejudice the position of the Bank.

8.2. A bank that omits an item that is marked as a quantitative disclosure in Section 11 of these Guidelines on the basis of Clause 8.1 (b) above, must disclose general qualitative information about the subject matter of the requirement, together with the reason for the omission.

9. Disclosures Policy

9.1. A bank shall have in place a formal disclosure policy approved by the board of directors which sets out the bank's approach for determining which disclosures it will make, and the internal controls over the disclosure process.

9.2. A bank shall ensure that appropriate and independent verification, whether internal or external, is performed in relation to all disclosure items required under these Guidelines, and take all reasonable steps to secure their accuracy and correctness.

9.3. To the extent that any of the disclosures required in these Guidelines are substantially similar to those required of the bank in accordance with applicable Accounting Standards, the bank may rely on the provision of such accounting disclosures in order to meet the requirements of these Guidelines.

PART III - SPECIFIC DISCLOSURE REQUIREMENTS

10. Introduction

10.1. For the purposes of Section 11, a bank must disclose the risks facing the bank and methodology for measuring and managing them. The bank must also disclose its risk management objectives and policies for each risk area identified in Section 11 below, including:

(a) its strategies and processes;
(b) the structure and organisation of the relevant risk management function;
(c) the scope and nature of risk reporting and measurement systems; and
(d) policies for hedging and mitigating risk, and processes for monitoring the continuing effectiveness of such policies.

10.2. Unless otherwise stated, a bank must, when disclosing any item stated in Section 11 that refers to the ‘Corporate’ exposures under the IRBA approach to credit risk, include each of the following asset sub-classes:

(a) Corporate;
(b) Corporate Small Business;
(c) Specialized Lending;

10.3. For the purposes of Section 11’ equities’ shall have the meaning attributed to an equity investment in accordance with the Accounting Standards.

11.Scope of Disclosures

(i) Corporate Structure

11.1. A bank must disclose the following items as regards to its corporate structure;

(a) The name of the bank or financial holding company incorporated in Malawi.

(b) A description of differences in the basis of consolidation for regulatory purposes compared to that required in accordance with Accounting Standards, together with a brief description of the entities within the banking group:

- that are fully consolidated;
- that are consolidated on a pro-rata basis;
- that are equity-accounted;
- that are deducted from eligible Tier 1 and Upper Tier 2 capital;
- from which surplus capital is recognised, if any; and
- that are neither consolidated nor deducted.

(c) Any restrictions or impediments on transfer of funds or regulatory capital within the banking group.

(ii) Capital

11.2. A bank must disclose the following as regards to its capital structure;

Qualitative Disclosures

(a) A description of the terms and conditions of the main features of all capital instruments included within Eligible Total Capital, particularly in relation to Tier 1 Capital, and other complex or hybrid capital instruments.

Quantitative Disclosures

(b) Elements of Eligible Tier 1 Capital as follows:

- paid-up ordinary share capital;
- disclosed reserves;
- paid-up non-cumulative preference shares;
- minority interests;
- Tier 1 capital instruments;
- any other instruments;
- deductions of goodwill, intangible assets and deferred tax assets;
- any other regulatory deductions from Tier 1 Capital.

(c) Total eligible capital.

11.3. A bank must disclose the following as regards to its capital adequacy;

Qualitative Disclosures

(a) A description of the approach to assessing the adequacy of its capital to support current and future activities.

Quantitative Disclosures

(b) Credit risk RWAs (excluding equity RWAs that are subject to the IRBA):

- for each asset sub-class subject to SA(CR);
- for each of the following asset sub-classes subject to IRBA:
  - corporate, sovereign and bank;
  - residential mortgage;
  - qualifying revolving retail; and
  - other retail;
- securitization exposures.

(c) Equity RWAs that are subject to the IRBA, as applicable:

- equity portfolios subject to simple risk weight method;
- equities in the banking book under the internal models method; and
- equity portfolios subject to PD/LGD approaches.

(d) Market RWAs calculated under: (i) SA(MR); and/or (ii) IMA, where appropriate.

(e) Operational RWAs calculated under the following approaches as applicable:

- BIA;
- SA(OR);
- AMA.

(f) Total RWAs and minimum capital requirements at the group level.

(g) Total CAR and Tier 1 CAR at the group level.

(h) Total CAR and Tier 1 CAR for each significant banking subsidiary.

(iii) Credit Risk

11.4. A bank must disclose the following general disclosures as regards to credit risk;

Qualitative Disclosures

(a) A description of the bank's policies in relation to:

- past due and impaired loans in accordance with applicable Accounting Standards;

- assessment of the level of individual and collective impairment provisions in accordance with applicable Accounting Standards;
- credit risk management;

Quantitative Disclosures

(b) Total gross credit exposures, and average gross credit exposures over the reporting period broken down by major types of credit exposure.

(c) Geographical (regional) distribution of credit exposures, broken down in significant areas by major types of credit exposure.

(d) Industry or counterparty-type distribution of credit exposures, broken down by major types of credit exposure.

(e) Residual contractual maturity breakdown by major types of credit exposure.

(f) By major industry or counterparty-type:

- Amount of classified loans and past due loans, provided separately;
- Individual and collective impairment provisions; and

- Charges for individual impairment provisions and charge-offs during the period.

(g) Amount of classified loans and past due loans, provided separately, broken down by significant geographic areas including, if practical, the amounts of individual and collective impairment provisions related to each geographical area.

(h) Reconciliation of changes in the provisions for loan impairment.

(i) For each asset sub-class, the amount of credit exposures subject to SA (CR), F-IRBA, and A-IRBA.

11.5. A bank must make disclosures for asset sub-classes subject to the standardised approach and supervisory risk weights in the IRBA as follows;

Qualitative Disclosures

(a) For each asset sub-class under SA(CR):

- The name of each ECAI used by the Bank, and the reasons for any changes in the use of an ECAI;
- The types of exposure for which each ECAI is used;

- A description of the process used to transfer public issue ratings onto comparable assets in the banking book; and
- The alignment of the alphanumerical scale of each ECAI used by the bank with relevant risk weights.

Quantitative Disclosures

(b) An analysis by risk-weights (including deducted exposures) for:

- Total rated and unrated credit exposures subject to SA(CR); and
- The aggregate of IRBA credit exposures, including equity investments, which are subject to supervisory slotting.

11.6. A bank must make disclosures for IRBA asset sub-classes as follows;

(a) A description of the:

- Structure of internal rating systems and the relationship between internal and external ratings;
- Use of internal estimates other than for IRBA capital purposes;

- Process for managing and recognising credit risk mitigation; and
- Control mechanisms for the rating system including independence, accountability, and rating system review.

Qualitative Disclosures

(b) A description of the internal ratings process, provided separately for five distinct asset sub-classes:

- Corporate, sovereign and bank;
- Equity investments (subject to the PD/LGD method);
- Residential mortgages;
- Qualifying revolving retail; and
- Other retail.

The description shall include, for each asset sub-class:

- The types of exposure included within the asset sub-class;
- The definitions, methods and data for estimation and validation of PD, (and for exposures under IRBA) LGD and EAD, including assumptions employed in the derivation of these variables1.

[1] A Reporting bank shall provide a broad overview of the model approach, describing definitions of the variables, and methods for estimating and validating those variables set out.

Quantitative disclosures: risk assessment

(c) For each asset sub-class as defined in (b) above, the following items shall be disclosed across a sufficient number of PD grades (including default) to allow for a meaningful differentiation of credit risk:

- Total exposures;
- Exposure-weighted average PD;
- Exposure-weighted average risk-weight; and
- Exposure-weighted average LGD (expressed as a percentage) for asset sub-classes subject to the advanced IRBA. For each retail asset sub-class the above items may be disclosed on a pool basis. For exposures subject to the advanced IRBA, the amount of undrawn commitments for each asset sub-class, together with an exposure-weighted average EAD for each asset sub-class.

Quantitative disclosures: historical results

(d) Actual losses (e.g. charge-offs and specific impairment provisions) in the preceding period for each asset sub-class (as defined above) and how this differs from past experience. A description of the factors that impacted on the loss experience in the preceding period — for example, has the bank experienced higher than average default rates, or higher than average LGDs and EADs.

11.7. A bank must make the following disclosures as regards to credit risk mitigation under SA (CR) and IRBA.

Qualitative Disclosures

(a) A description of the following elements in addition to the general disclosures set out in 10.1(d) with respect to credit risk mitigation:

- its policies and processes for, and an indication of the extent to which the bank makes use of, on- and off-balance sheet netting;
- its policies and processes for collateral valuation and management;
- the main types of collateral taken by the bank;
- the main types of guarantor/credit derivative counterparty and their creditworthiness;
- information about (market or credit) risk concentrations within the mitigation taken; and

- an indication of the IRBA risk components that are affected by the recognition of credit risk mitigation, according to the approaches used by the Bank.

(b) For each separately disclosed credit risk asset sub-class under SA(CR) and/or F-IRBA, the extent to which credit exposures are covered by:

- eligible financial collateral; and
- other eligible IRB collateral; after the application of haircuts.

Quantitative Disclosures

(c) For each separately disclosed asset sub-class under the SA(CR) or IRBA, the amount by which credit exposures have been reduced by guarantees/credit derivatives.

11.8. A bank must make general disclosures for exposures related to counterparty credit risk ("CCR") as follows;

Qualitative Disclosures

(a) A description of the following elements in relation to its exposures related to derivatives and CCR:

- The methodology used to assign economic capital and credit limits for counterparty credit exposures;
- The policies for securing collateral and establishing credit reserves;
- Policies with respect to wrong-way risk exposures; and
- The impact of the amount of collateral the bank would have to provide given a credit rating downgrade.

Quantitative Disclosures

(b) Gross positive fair value of contracts, netting benefits, netted current credit exposure, amount and type of collateral held, and the net derivatives credit exposure. The notional value of credit derivative hedges, and the distribution of current credit exposure by types of credit exposure.

(c) Credit derivative transactions that create exposures to CCR (notional value), segregated between use for the institution's own credit portfolio, as well as in its intermediation activities, including the distribution of the credit derivatives products used, analysed further in terms of protection bought and sold within each product group.

(d) The estimate of alpha if the bank has received supervisory approval to estimate alpha.

11.9. A bank must make disclosures as regards to securitisation under Standardised or IRB Approaches as follows;

Qualitative Disclosures

(a) A description of the following items in relation to the disclosure requirement set out in paragraph 10.1 with respect to securitisation (including synthetic securitisation):

- the Bank's objectives in relation to its securitisation activities, including the extent to which these activities transfer credit risk of the underlying securitized exposures away from the bank to other entities;
- the roles played by the bank in the securitization process and an indication of the extent of the bank's involvement in each of them; and;
- the regulatory capital approaches that are applicable to the bank's securitisation activities.

(b) Summary of the Bank's accounting policies for securitisation activities, including:

- whether the transactions are treated as sales or financings;
- recognition of gain on sale;

- key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes; and
- treatment of synthetic securitisations if this is not covered by other accounting policies (e.g. on derivatives).

(c) Names of ECAIs used for securitisations and the types of securitisation exposure for which each agency is used.

Quantitative Disclosures

(d) Aggregate amount of securitisation exposures retained or purchased and the associated IRBA capital charges for these exposures broken down into a meaningful number of risk weight bands. Exposures that have been deducted entirely from Tier 1 capital, credit enhancing interest-only strips deducted from Total Capital, and other exposures deducted from total capital shall be disclosed separately by type of underlying asset.

(e) For securitisations subject to the early amortization treatment, the following items by underlying asset type for securitised facilities:

- the aggregate drawn exposures attributed to the seller's and investors' interests;
- the aggregate IRBA capital charges incurred by the bank against its retained (i.e. the seller's) shares of the drawn balances and undrawn lines; and
- the aggregate IRBA capital charges incurred by the bank against the investor's shares of drawn balances and undrawn lines.

(f) For a bank that applies the standardised approach to securitisation, the items in (e) and (f) above using the capital charges under the SA(SE) approach.

(g) Summary of current year's securitisation activity, including the amount of assets securitised by exposure type, and the recognised gain or loss on sale by asset type.

(iv) Market Risk

11.10. A bank using the Standardised Approach for measuring market risk must disclose the following;

Qualitative Disclosures

(a) A description of risk management objectives and policies as set out in paragraph 10.1 for market risk including the portfolios covered by the standardised approach.

Quantitative Disclosures

(b) The capital requirements for the following risks computed under the standardized approach:

- interest rate risk;
- equity position risk;
- foreign exchange risk; and
- commodity risk

11.11. A bank using the internal models approach (IMA) for trading portfolios must make the following disclosures.

(a) A description of the extent of compliance with the "Prudent valuation guidance" for positions held in the trading book and the valuation methodologies employed by the Bank, in addition to the general disclosures set out in paragraph 10.1 on market risk.

(b) A description of the soundness standards on which the bank's internal capital adequacy assessment is based, as well as the methodologies used to achieve a capital adequacy assessment that is consistent with those soundness standards.

Qualitative Disclosures

(c) For each portfolio covered by the IMA:

- the characteristics of the models used;
- a description of stress testing applied to the portfolio; and
- a description of the approach used for backtesting/validating the accuracy and consistency of the internal models and modeling processes

(d) The scope of acceptance by the supervisor.

Quantitative Disclosures

(e) For trading portfolios under the IMA:

- The high, mean and low VAR values over the reporting period and period-end; and;
- A comparison of VAR estimates with actual gains/losses experienced by the bank, with analysis of important ‘outliers’ in backtest results.

(v) Operational Risk

11.12. A bank shall disclose the following as regards to operational risk;

(a) A description of the regulatory approach or approaches to the calculation of operational risk capital requirements, in addition to the general disclosures set out in paragraph 10.1 in relation to the management of operational risk.

(b) A description of the AMA, if used by the Bank, including a discussion of relevant internal and external factors considered in the bank's measurement approach, and in the case of partial use, the scope and coverage of the different approaches used.

(c) For a bank that uses the AMA for calculating operational risk capital requirements, a description of any use of insurance for the purpose of mitigating operational risk.

(vi) Equities

11.13. A bank must disclose the following as regards to equities.

Qualitative Disclosures

(a) A description of the following items in addition to the general disclosures set out in paragraph 10.1 with respect to equity risk:

- differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons; and
- its policies in relation to the valuation and accounting treatment of equity holdings in the banking book. This should cover the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.

(b) The value of equities held in the balance sheet of the Bank, and the fair value of those investments if different.

(c) The types and nature of equities, including the amount that can be classified as:

- publicly traded; and;
- privately held.

(d) The realised gains (losses) arising from sales and liquidations of equities in the reporting period.

(e) Total unrealized gains (losses) that have not been reflected in the income statement of the Bank, and the extent to which these have been included in Tier 1 capital or Tier 2 capital.

Quantitative Disclosures

(f) An analysis of equity investments analysed in terms of appropriate equity groupings and exposure-weighted average risk weights, consistent with the methodology employed by the Bank. Equity investments that are deducted shall also be disclosed in an accompanying note. An explanation of any material difference between the value of equities calculated in accordance with the relevant Accounting Standards and the regulatory definition of equity investments.

(vii) Interest Rate Risk in the Banking Book

11.14. A bank must disclose the following as regards to interest rate risk in the banking book.

Qualitative Disclosures

(a) A description of the key assumptions made by the Bank, including assumptions regarding loan prepayments and behaviour of non-maturity deposits, and frequency of IRRBB measurement in addition to the general disclosures set out in paragraph 10.1 in respect of IRRBB.

Quantitative Disclosures

(b) The changes in earnings or economic value (or relevant measure used by the bank) for upward and downward rate shocks according to management's method for measuring IRRBB, broken down by currency if appropriate.

Feedback

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