

Chapter 2

Monetary Policy, Financial Stability and Macro-prudential Regulation: An Indian Perspective

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2.1 Introduction

The global crisis of 2007 seems to have shaken the preternaturally unflappable equanimity of central bankers the world over, while simultaneously giving a rude jolt to all those economists serenely confident in the benevolence of the “invisible hand” and the “efficiency” of financial markets. As a description of the crisis, *Slapped by the Invisible Hand* (the title of a recent book by Gorton (2010)) seems a euphemism, when one considers the extent of the collateral damages inflicted by the events on huge sections of society, whose only fault lay in their unquestioning trust in a system which was being deliberately manipulated by a greedy few.

There are several competing theories of what triggered the global crisis in the USA,¹ but a common strand running through all explanations emphasises three factors: (1) a myopic monetary policy of the Federal Reserve Board (FRB) under the tenure of Greenspan, (2) asset prices boom, especially in residential real estate and (3) the emergence of an inadequately regulated “shadow banking” sector. Largely flowing from such a perspective, the post-Lehman academic and policy debates on central banking policy (a broad term to include monetary policy, regulation and supervision) have revolved along the following two broad sets of issues:²

¹ See in particular Brunnermeier 2009, Gorton (2008, 2010), Giovanni and Spaventa 2008, Reddy 2009 etc.

² Of course, slightly broader issues bearing on global current account imbalances, fiscal deficits and the recasting of the global financial architecture have also figured in international forums such as the G-20. However, we have focused on the narrower issues outlined in the text as of immediate medium-term significance.

1. Monetary policy and asset prices
2. Financial stability and macro-prudential regulation

In addition, in our opinion, there are three other issues, which have seen much less discussion but which have an important bearing on the future regulatory landscape, especially in emerging market economies (EMEs) such as India. These are:

3. Rules versus principles-based regulation in the financial sector
4. Integrated financial supervision
5. Regulatory and supervisory independence (RSI) of financial regulatory and supervisory institutions

We take up each of the above five issues for discussion. Much of the current discussion on these issues has been located in the advanced economies' context, which is partly attributable to the fact that the severity of the crisis was much more in evidence there. However, the rapid growth of the shadow banking sector in the EMEs, and the liberalization of trade in financial services under General Agreement on Trade in Services (GATS) is almost certain to increase EMEs' vulnerability to crises in the future. Such a possibility is particularly strong in the Indian context, where the political leadership is highly enthused over liberalization (especially financial liberalization) prospects. Hence, a discussion of the various issues from an EME (or more specifically Indian) perspective would not only be beneficial in preventing a perpetration of mistakes committed elsewhere in the build-up to the 2007 crisis, but also indicate possible strategies for pre-emption of the worst consequences of such a crisis were it to recur.

The remainder of the chapter is organized as follows. Section 2 takes up for discussion the revisions in thinking on monetary policy that have occurred in the wake of the crisis, with special emphasis on how monetary policy should respond to developments in asset markets. Section 3 offers a critical overview on the key role of macro-prudential regulation in promoting financial stability. Sections 4 (rules vs. principles), 5 (integrated financial supervision) and 6 (RSI) deal with a somewhat broader set of issues that are fraught with long-term implications for the evolution of financial systems and their regulation in EMEs. The final section (Sect. 7) concludes.

2.1.1 Rethinking Monetary Policy in the Wake of the Crisis

A. "Slipping Transmission Belt" of Monetary Policy: Long before the current global crisis set in, it was becoming increasingly evident that the profound institutional changes set in motion by the successive globalization waves of the 1980s and 1990s had considerably reduced both the manoeuvrability space and the efficacy of monetary policy. Several factors seem to be at play here (see, e.g., Nachane and Raje 2007, etc.) including most prominently (1) unchecked financial innovation which led to the emergence of several new near substitutes for *money*, (2) a relative

decline in the role of banks in credit creation, (3) the switchover from a reliance on direct monetary policy instruments such as cash reserve ratio (CRR), statutory liquidity ratio (SLR), credit ceilings, etc. to indirect measures such as open market operations (OMO) and repo rates and (4) unrestricted global capital flows. The mechanics via which such changes weakened the link between monetary policy and the credit market have been detailed, for example, in D'Arista (2009) (to whom we also owe the term “slipping transmission belt”).

B. Asset Prices and Financial Fragility: The issue of whether asset prices should figure in discussions of monetary policy has always been a contentious issue. The precrisis period was marked by a general consensus among mainstream academics and policymakers regarding three issues viz. (1) that commodity inflation control should be the overriding (if not exclusive) objective of monetary policy, (2) that asset price bubbles are better left alone as attempts to control (or worse “prick”) such bubbles could lead the economy into dangerous territory and (3) if, and when, asset prices burst central banks should “mop up the mess,” i.e. go into the “lender of last resort” act (see Greenspan 2004; Blinder and Reis 2005; Mishkin 2007, etc.). This viewpoint (often referred to as the Jackson Hole Consensus following Issing (2009)) simply stated views price stability and financial stability as highly complementary and mutually consistent objectives for a central bank. The intellectual underpinnings of the Jackson Hole Consensus is based on the conventional Friedmanian argument that financial instability is the outcome of *unexpected shocks* to the inflation level, mainly arising from over-enthusiastic central banks trying to stimulate the economy beyond its *natural* rate (see Friedman and Schwartz 1963; Schwartz 1998, etc.). The global crisis brought out the fatal flaw in this consensus and gradually prompted an academic shift of opinion to an alternative viewpoint, which argued for a less benign relationship between monetary and financial stability.³ The essence of this alternative viewpoint (see Borio and Lowe 2003; Bean 2004, etc.) sees not only monetary stability coexisting with financial instability but occasionally also a causal nexus from the former to the latter. Periods of monetary stability (such as the so-called Great Moderation spanning the decade and a half from 1990 to 2007) are often accompanied by output growth and generate bullish expectations of future prospects. These, in turn, lay the foundations for booms especially in equity markets and real estate. Demand for credit soars for investment in highly profitable rising asset markets. Central banks (exclusively focussed on commodity market inflation) may keep interest rates low,⁴ stimulating high-risk speculative investment. This sets the stage for the kind of asset price booms which have preceded many crisis episodes including those of 1893, 1907, the Great Depression (1929–1933), the Asian Crisis of 1997–1998 and of course the current global crisis beginning with the Lehman collapse of 2007. Set against this background of history repeating itself, it is indeed a surprise that policymakers

³ The various alternative theories in this regard are critically reviewed in Tymoigne 2006.

⁴ As pointed out by Rajan 2005, artificially low interest rates (benchmarked say, against a conventional Taylor Rule) enhance financial fragility by feeding the “disaster myopia” psychology of investors.

in advanced market economies (AMEs) failed to read the message in the amply visible evidence of high growth rates of credit and monetary aggregates, deteriorating lending standards, rapidly rising asset prices, unnaturally low spreads and insurance premia, etc. (see Hein and Truger 2010).

The implications of this alternative viewpoint for monetary policy are straightforward viz. that the central banker cannot afford to play the combined role of a *bystander* while an asset boom is in progress and a *good Samaritan* once the boom goes bust of its own accord. But agreement on this general principle still leaves open the question of the exact form of central bank intervention in asset markets. Basically such intervention could assume either of three forms (including combinations): Firstly, monetary policy could be made responsive to asset price developments; secondly, by a stricter system of controls on capital requirements in banks and other financial institutions (FIs) and thirdly, by restricting certain types of trades in asset markets (see Friedman 2010). We will discuss only the first of these possibilities in this section; the other two falling in the domain of prudential measures are discussed in the next section.

C. Monetary Policy Responsiveness to Asset Prices: The issue of monetary policy responsiveness to asset prices essentially hinges upon the role of asset prices in *predicting* future consumer prices inflation. In their seminal paper, Alchian and Klein (1973) criticise the conventional definition of a consumer price index (CPI) as a measure of the *yearly cost of living index* and seek to replace it by the notion of a *lifetime cost of living index*. This, in turn, implies expanding the definition of the consumer basket to include *expected* future consumption. In an important paper, Shibuya (1992) shows that a *lifetime cost of living index* can be approximated by a weighted sum of conventionally measured inflation and asset price inflation. Asset prices thus enter the proposed index as proxies for the *unobservable* future consumer prices. The entire case for including asset prices in an overall measure of inflation⁵, by this logic, hinges on an essentially empirical question: How good are asset prices as a measure of expected future consumption prices? While some supporting empirical evidence is indeed found in selected cases (see Filardo (2000) for evidence in the Japanese and UK experiences of the late 1980s, Bryan et al. (2002) for the USA and RBI (2010) for some Indian evidence), there are three important reasons why the link between asset prices and commodity prices may be a highly tenuous one. Firstly, even though the ideal theoretical measure of Alchian and Klein's index includes the entire spectrum of asset prices available to a consumer, in practice, because of data limitations, only two assets are considered viz. real estate and equity. Secondly, real estate and equity markets may be influenced by a number of factors apart from inflation expectations. Finally, asset prices may affect consumer prices with long (and variable) lags. But even if the link between asset prices and general inflation is not very direct or strong, a monetary policy of *benign neglect* of asset prices could be doing more harm than good as brought out

⁵ The methodology of how this is to be done is expounded in Shibuya 1992, Bryan et al. 2002, etc.

amplify by the Japanese “lost decade” experience of the 1990s and the recent crisis in the USA.

While some kind of a loose consensus seems to have built up in the post-crisis years around the desirability of a monetary policy responsive to asset prices, the distinction between explicitly *targeting* asset prices or using them as mere *indicators* is often slurred over. In the latter viewpoint, which also seems to be the majority one, asset prices figure in the monetary policy calculus to the extent that they are informative about general inflation. By contrast, the use of asset prices as *targets* has definite welfare connotations attached to the levels of asset prices. The case for using asset prices as explicit targets seems to have been first made by Goodhart (1995), who suggested augmenting the inflation target of the central bank by an asset inflation factor. There are two points which in our opinion seem to be in favour of using asset price inflation as a target rather than an indicator in EMEs. Firstly, affordable housing prices are a key component in social welfare of societies with large sections of the poor and middle class. Secondly, in a situation where asset prices are rising but the general commodity inflation is stable, a rise in interest rates may be difficult to justify to the public if asset prices are being merely used as an indicator (as outlined in Yamaguchi (1999) and Okina et al. (2000) this reservation seems to have been important in the Bank of Japan’s inertia with respect to monetary tightening in the late 1980s). With asset inflation as an explicit target, it would be relatively easier to provide such justification. There seems to be some limited evidence (see Lo 2010; Akram and Eitheim 2008) that including real estate price inflation in an augmented Taylor Rule could lead to some improvement in overall macroeconomic performance and the case for including equity price inflation in a monetary policy reaction function dates back to Tobin 1974.

2.1.2 Financial Stability and Macro-Prudential Regulation

Financial stability as an explicit concern of central banks certainly antedates the recent global crisis in most advanced countries and several EMEs (including India). The crisis, however, has brought it into a much sharper focus. Even more importantly, the crisis brought about a shift of emphasis from *micro-prudential* regulation (essentially centred on a partial-equilibrium approach to regulation aimed at preventing the costly failure of individual financial institutions (FIs)) to *macro-prudential* regulation (constituting a general-equilibrium approach to regulation aimed at safeguarding the financial system as a whole). The string of successive failures of FIs in the USA and Europe subsequent to the Lehman collapse highlighted the inadequateness of a micro-prudential regulatory structure, geared to addressing *idiosyncratic* risks specific to individual FIs. Instead, it was becoming increasingly clear that financial crises tend to be typically characterized by a Domino scenario in which the collapse of a few key FIs is followed by a general collapse of the financial system and that only a regulatory and supervisory (henceforth R&S) framework

designed to address *systemic risk*⁶ provides a measure of insurance against a general “Minsky moment” (Minsky 1986; Cassidy 2009). Inter-institutional linkages, accompanied by low capitalization and an excessive reliance on short-term sources of funding (maturity mismatch), often lead to general rollover problems, thus creating a potential for financial crises. As noted by Whelan (2009), “systemic risk can often arise even with individual institutions having good risk-management systems in place. Further, such systemic episodes can be triggered by relatively minor impulses. It is often generated by individual institutions taking decisions in the interest of their own prudent risk management”. The Basel II framework (2004) did play an important role in putting (globally active) individual FIs (especially banks) on a sound footing but with its emphasis on micro-prudential regulation it fell short of forestalling the global financial crisis of 2007–2008. Both the US Dodd-Frank Act (2010) and the proposed Basel III framework seek to steer financial regulatory (and supervisory) structures towards macro-prudential regulation. It is not possible here to go into the details of each set of these proposals;⁷ instead, we try to present (in broad caricature) the major *desiderata* of macro-prudential regulation stressed in the official and academic literature. In conclusion, we also offer some additional considerations germane to the Indian context.

Generally speaking, the post-crisis discussion on regulation has spanned five distinct areas viz.:

- a. Strengthening of R&S
- b. Expanding the scope of R&S to include the *shadow* banking sector
- c. Strengthening prudential standards of FIs
- d. Reducing welfare costs of financial failures
- e. Devising market incentives for prudent behaviour

(see *de Larosiere Group* (EU) (Feb 2009), *Working Group 1* of the G20 (March 2009) and Hanson et al. 2011):

Each of these aspects is now discussed at some length.

A. Strengthening R&S: One of the key (though not sole) factors identified in the perpetration of crises, past or present, seems to be a lax precrisis regulatory system (Mohan 2009; Stiglitz 2009; Wray 2011, etc.). It was felt that R&S has not only to be strengthened but that its scope also needs to be extended considerably. For strengthening R&S, two measures seem to be in order viz.

⁶ There are several (closely related) definitions of systemic risk and we mention here the two most commonly used. The G-10 (2001) define systemic risk as “the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have adverse effects on the real economy”, whereas the IMF-BIS-FSB (2009) definition runs somewhat parallel as “a risk of disruption to financial services that is (1) caused by an impairment of all or parts of the financial system and (2) has the potential to have serious negative consequences for the real economy.”

⁷ The Basel III proposals are outlined in BIS (2010) whereas the Dodd-Frank proposals are critically discussed and evaluated in Acharya et al. (2010, 2011).

A1. *Entrusting a special regulatory authority (either an existing one or a newly constituted one) with an explicit financial stability mandate:* Traditionally, the central banks of most countries have been primarily entrusted with the mandate of monetary stability (inflation targeting). However, as mentioned above, the recent global crisis has shattered the Jackson Hole consensus that monetary stability brings financial stability in its wake (see, e.g., Borio 2011; Galati and Moessner 2011). Considerations of financial stability can be taken care of either by (1) expanding the mandate of the central bank to additionally include financial stability or by (2) establishing a separate regulatory authority explicitly focused on financial stability.

A2. *Ensuring coordination between different regulatory authorities:* Any modern economy is characterized by a diversity of FIs, each under a different R&S authority (by way of example, in India, the Reserve Bank of India (RBI) regulates and supervises operations of commercial and cooperative banks, the National Housing Bank (NHB) is the R&S authority for housing finance and mortgage companies, the Securities and Exchange Board of India (SEBI) oversees the functioning of equity and bond markets, etc.). Jurisdictional conflicts (or “turf wars”) among such distinct R&S authorities are common and hence the need for inter-regulatory co-ordination.

B. Expanding the Scope of R&S: In the opinion of several analysts, the defining feature that sets the current crisis apart from other crises of comparable intensity in the past is the critical role played by the *shadow* banking sector. In the last three decades or so, there has been a proliferation of bank-like institutions engaged in lending but with no access to public deposits or central bank funding. Instead, they rely on funding via *asset-backed commercial paper* or in the repo market against collateral. The institutions typically constituting the *shadow* banking sector are hedge funds, money market mutual funds, private pension funds, special purpose vehicles (SPVs), etc. The growth of such institutions is attributable to several factors including the emergence of *securitization*⁸ and new financial products (such as credit derivatives, collateralized debt obligations (CDOs), etc.) as well as the proliferation of the *universal banking* syndrome (see Gorton and Souleles 2006).

Most crisis narratives assign a key culpable role to shadow banking institutions. In the case of the current crisis (especially as it unfolded in the USA), the collapse of the market for *asset-backed commercial paper* (often asset classes completely unrelated to sub-prime mortgages) created a *liquidity panic* among participants unable to locate where exactly the source of the problem lay (see Brunnermeier and Pedersen 2009). In standard parlance what was hitherto considered as *information-insensitive* debt suddenly turned *information sensitive*. Ex post wisdom then suggests that the shadow banking sector lurking in the penumbra of the traditional banking sector and escaping many of the regulations traditionally levied on depository institutions should be brought under the regulatory pale. The large number of institutions in the shadow banking sector and the opacity of their operations pose

⁸ Securitization is essentially a form of off-balance sheet banking, in which SPVs are used as a conduit for channelling assorted bundles of bank loans to the capital market in the form of “securities.” The most prominent example of this phenomenon is the mortgage-based securities (MBS) which played a key role in the current crisis.

formidable obstacles in the way of placing them on a regulatory par with traditional depository institutions.

One criticism of the currently prevailing paradigm of regulation relates to it being determined by the *form* rather than the *function* of a financial institution. Thus, several nonbank financial institutions (NBFIs), even though they take on several banking functions, continue to be treated for regulatory purposes as NBFIs rather than banks. The resultant scope for *regulatory arbitrage* has been one of the factors responsible for the current ballooning of the shadow banking sector all over the world (India being a leading EME example). If instead regulations are made to depend on the type of loan exposure irrespective of its origination (whether by a bank, an NBFI or a money market mutual fund), not only would the scope of regulation be enhanced but the resultant harmonization across all FIs would diminish regulatory arbitrage and consequently remove one of the major incentives for the spawning of shadow banking institutions. Several suggestions have been made as to the modalities of bringing about such a change (see e.g. Kashyap et al. 2008; Geanakoplos 2010, etc.). Most of these suggestions are some variants of the initial and maintenance margin requirements applicable to investors in equities,⁹ whereby the holder of a tranche in an asset-based security would be obligated to maintain a margin (or *haircut* in the financial markets' jargon) depending on the seniority of the tranche (see Hanson et al. 2011, p. 16).

C. Strengthening Prudential Standards: The crisis has also brought out the weaknesses in the existing prudential standards, which under Basel II, seem to have been exclusively focussed on capital requirements. There is a growing recognition that prudential norms need to encompass several additional interrelated dimensions and that the new regulatory architecture likely to emerge in 2013 under the Basel III aegis must satisfactorily address the following set of issues:

C1. Improving the Quality of Bank Capital: Common equity (defined as *common* shares plus retained earnings minus *goodwill*) is generally regarded as higher quality capital than *preferred* equity. Hence, given the objective of helping banks recapitalize quickly in the event of stress, it may be desirable to increase the share of common equity in bank capital. Reflecting this logic, the Basel III proposals have increased the ratio of Tier 1 capital to total risk-weighted assets from 6% under Basel II to 8.5%, while simultaneously putting in place a staggered system of restrictions on distribution of earnings if the ratio of common equity in Tier 1 (to risk weighted assets) falls short of the minimum of 7%. Additionally, Tier 2 capital has been strengthened while Tier 3 capital has been dropped altogether.

C2. Pro-cyclicality of Capital Requirements: That the capital standards imposed under Basel I and Basel II tend to be pro-cyclical has been well known to economists for quite some time (see Drehmann et al. 2011, for an early critique of this feature). They can hence be a possible accentuating factor in any crisis, by leading to shrinkage in the size of the bank balance sheets. As the current crisis runs its

⁹ In India, members of the BSE and NSE have to maintain several types of margins with these Exchanges including most prominently daily margins, mark-to-market margins, carry forward margins, ad hoc margins, etc.

course, there is a greater realization among central bankers globally that ways had to be found to counter this pro-cyclicality. At least three operational suggestions have been made in this context: (1) requiring FIs to build up *capital buffers* during economic expansions (which could then be unwound in times of recession) (Ghosh and Nachane 2003; Gordy and Howells 2006 etc.); (2) *capital insurance* wherein a bank insures against a capital shortfall via a collateralized (insurance) policy (see Kashyap et al. (2008) for a detailed exposition of this concept) and (3) introducing so-called *contingent convertibles* (securities that are issued as debt by a bank but which are automatically convertible into equity if regulatory capital of the bank falls below a certain threshold; see Flannery 2005; French et al. 2010; Hanson et al. 2011, etc.).

C3. Leverage of Financial Institutions: An important amplification factor for the current crisis has been not only the high degree of leveraging of many FIs but also the fact that this leveraging has very often been quite opaque (see Kalemli-Ozcan et al. 2011). Reflecting the need for more accurate measures of balance sheet exposures, the following suggestions have emerged: (1) a stronger focus by regulators on loan-to-value ratios (LTVs): The RBI, for example, now insists on a cap of 75 % on the LTV ratio, with risk weights on exposures varied according to the LTV ratio; (2) limits on leverage ratios of banks. In tune with this thinking, Basel III proposes to introduce a minimum leverage ratio of 3 % defined as the ratio of Tier 1 capital to total exposure (on and off balance sheet).

C4. Other Prudential Measures: Several other prudential measures have also been suggested and discussed in detail in the literature. An indicative list would comprise: (1) higher loan-loss provisioning norms (Saurina 2009): In India, for example, loan loss provisioning has been steeply raised by the RBI in the wake of the crisis (it currently stands at 70 %); (2) imposing higher capital requirements on *systemically important* FIs (see Pennacchi 2010; Bullard et al. 2009 etc.): Once again referring to the Indian case, systemically important nonbank financial intermediaries are subject to a higher capital to risk-weighted assets ratio (CRAR) of between 12 and 15 %, as opposed to the regularly applicable CRAR of 9 % for banks; (3) stress-testing exercises to be conducted periodically to monitor leveraging on an ongoing basis (Lopez 2005; Matsakh et al. 2010, etc.); (4) disclosure requirements for complex structured products and reducing pro-cyclicality of accounting standards (Borio and Tsatsaronis 2005; Novoa et al. 2009; etc.); (5) improved valuation methodologies for collateral (see Piterbarg 2010); (6) risk concentration limits involving ceilings on growth of particular types of exposures (BIS 2006; Bonti et al. 2006, etc.) and finally (7) the establishment of clearing houses in Over the Counter (OTC) derivatives markets (see Norman 2011; Pirrong 2011, etc.). About 75 % of the OTC derivative contracts in India are routed through a centralized exchange viz. the Clearing Corporation of India Ltd. (CCIL).

D. Reducing Welfare Costs of Financial Failures: The welfare costs of financial crises are generally severe and fall disproportionately on disadvantaged groups in any society, and the current crisis is hardly an exception. With a view to reducing such costs, the following two major suggestions have been made.

D1. *Early Warning Diagnostic System*: Early warning systems purport to detect underlying financial fragilities well in advance of a crisis, permitting central bankers to initiate pre-emptive action (see Bussiere and Fratzscher 2006, etc.). The RBI introduced the Prompt Corrective Action (PCA) scheme in December 2002, under which the central bank would initiate *structured* as well as *discretionary* actions in respect of banks, which have hit certain trigger points (defined in terms of CRAR, net nonperforming assets (NPA) and return on assets (ROA)).

D2. *Orderly Closure Rules*: The instituting of Orderly Closure Rules for important FIs, as prevalent in the USA for banks under the Federal Deposit Insurance Corporation (FDIC) Improvement Act and Competitive Equality Banking Act. Under this act, apart from capital-based triggers, there are stipulations ensuring that banks are closed before it is too late (i.e. before they go into negative worth territory). The brunt of the loss is borne by shareholders and the FDIC becomes the receiver. A temporary bridge bank is set up to pay off depositors and creditors and organize the *fire sale* of assets. In India, to date no such provision exists—failing banks are either merged with another stronger (public or private) bank or there is capital infusion from the government. Both courses have obvious drawbacks (see Goldstein 2008). Pending the initiation of such closure rules, suggestions have been made in the Indian context to raise the limits for deposit insurance (Nachane 2009) and to replace the existing flat premium with a risk-sensitive premium (see Government of India 2009).

E. Devising Market Incentives for Prudent Behaviour: The issue of *market discipline* was brought into the forefront of debates on sound regulatory practices by the great emphasis laid on it by Basel II, as one of its three pillars (Pillar III) of sound prudential regulation. *Market discipline* is a generic term referring to the monitoring of FIs by market participants and, in the Basel II schemata, is sought to be achieved by imposing various kinds of disclosure requirements on FIs (most particularly banks) relating to their capital, assets, credit risk, market risk, operational risk, etc. The rationale for disclosures is to provide adequate information to enable counterparties (mainly depositors, shareholders and occasionally junior/subordinated debt holders) to assess whether the available capital is sufficient to meet measured and nonmeasured risks. To the extent that such disclosures are comprehensive and objective, it is expected to assist market participants in judging how a bank's management of its capital adequacy relates to its other risk management processes and its ability to withstand future volatility. The BIS has recently elaborated on the recommendations of the New Basel Capital Accord concerning the nature of information which should be disclosed under this pillar. The salient components of this information (for a bank) comprise: (1) the structure and components of bank capital, (2) the terms and main features of its capital instruments, (3) the accounting policies used in the valuation of assets and liabilities and for provisioning and income recognition, (4) qualitative and quantitative information about risk exposures and strategies for risk management, (5) its capital ratio and other data related to its capital adequacy on a consolidated basis and (6) a breakdown of its risk exposures. The information needs to be supplemented by an analysis of factors affecting the banks'

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