

LETTER TO CEOS OF ALL ADIs, ABA, CUSCAL, CREDITLINK, AAPBS, IBSA, AFC (Australian Finance Conference)

Implementation of the New Basel Capital Accord

As you would be aware, the Basel Committee on Banking Supervision recently released its third consultative document on the New Basel Capital Accord (also known as Basel II). APRA welcomes the proposals for more risk sensitive capital adequacy regulation contained in these proposals. Although some fine-tuning of the latest proposals will no doubt occur, APRA is now in a position to provide a broad outline of how it intends to implement the new Accord. This should provide greater certainty to banks and other authorised deposit-taking institutions (ADIs) as to whether APRA will require that they adopt the standardised or the more advanced model-based approaches under the new Accord. It will also assist ADIs in deciding the level of resources needed to meet the requirements of the new Accord over the coming years.

Credit Risk

APRA expects the four major banks, as large internationally operating banks, to seek to implement one of the internal-ratings based (IRB) approaches for credit risk when the Accord comes into effect. Other locally incorporated banks operating in Australia, which are organisationally and operationally less complex, are expected initially to adopt the standardised approach for credit risk. While these banks may apply to adopt the IRB approaches they will need to meet the same high level of requirements that will apply to all banks in regard to the qualitative and quantitative criteria necessary for IRB approval.

A good many technical issues have still to be determined. As part of the process, APRA will need to consider some of the definitional issues regarding loan types. Among these, given proposals to lower the standardised housing risk weight, it will be necessary to better specify housing loan definitions relating to loans reliant upon lenders mortgage insurance and to cover developments such as low-doc and no-doc loans. IRB institutions will also need to consider the relative performance of such loans in segmenting their residential mortgage portfolios.

Operational Risk

APRA will require banks adopting the IRB approaches also to adopt the advanced measurement approach (AMA) for operational risk. AMA will not be available to non-IRB banks.

For non-IRB banks, APRA is still considering the simpler operational risk approaches that have been proposed by the Committee; in particular whether it will offer one or both of the basic indicator and standardised approaches, or a modified approach along the lines of the Committee's recently proposed alternative standardised approach.

Interest Rate Risk in the Banking Book

APRA also intends to require those banks that will be using the more sophisticated approaches to calculate regulatory capital for credit and operational risks, to hold a mandatory capital requirement for interest rate risk in the banking book. For those banks that do not have in place an approved internal model, the requirement to hold regulatory capital against interest rate risk will be determined on a case-by-case basis. In the latter instances, the capital held will be based on a risk measurement method to be prescribed by APRA.

“Other Risks”

Again, for those banks that will be using the sophisticated approaches to calculate regulatory capital for credit and operational risks, APRA would expect that their own capital allocation models and stress-testing processes would take into account risks other than those covered by Pillar 1 of the new Accord. APRA will be meeting with those banks to assess how they take into account the full range of risks in their own capital allocation models. These risks include business/strategic risk and credit concentration risk, which will be taken into account under Pillar 2. Pillar 2 requirements will also address the impact of the credit cycle on regulatory capital adequacy assessments.

Overall Regulatory Capital Requirements

The range of calculation approaches that will be available to banks under the new Accord for credit and other key risks is a deliberate move by supervisors away from a “one-size-fits-all” approach. Accordingly, none of the approaches are viewed by APRA as necessarily superior or inferior for all institutions. There is no generically “right” answer across the deposit-taking sector and whether an approach is appropriate on-balance for particular institutions will depend on their circumstances.

Multiple calculation approaches for different institutions may raise potential competitiveness issues. Indeed, this has been a major theme in APRA’s past submissions to the Basel Committee on the Basel II proposals. When implementing the new Accord in Australia, APRA will seek an equitable balance among the various calculation options that will be available. This will require careful assessment of the whole reform package and not just a narrow judgement based on particular aspects of the proposals.

APRA will be approving the more advanced approaches only where it is satisfied that banks have in place robust risk management frameworks, including conservatively estimated and validated model parameters that are well embedded in the banks’ day-to-day risk management processes.

Although APRA expects that those banks using the IRB approaches may have some reduction in regulatory capital from the levels required under the standardised approaches, at present any reduction has not been quantified. In particular, APRA, and indeed most other international regulators, have not yet fully assessed the impact on regulatory capital that Pillar 2 will have on those banks using the IRB and AMA approaches. While APRA may agree to some regulatory capital reduction, the recent quantitative impact study is not considered indicative of the final regulatory capital position under Basel II. In particular, this study did not attempt to assess the impact on

banks' regulatory capital of the requirements relating to ratings migration, stress testing, interest rate risk in the banking book and other risks noted above. These requirements are likely to add substantially to banks' final regulatory capital outcomes and must be taken into account in any full assessment of the impact of the Basel II proposals. APRA's position is that we will accept moderate regulatory capital reductions for IRB banks, but this reduction must be justified by the banks in question.

It is also envisaged that institutions on the less sophisticated approaches will, on average, experience a modest reduction in regulatory capital.

Foreign Bank Subsidiaries

In the case of foreign bank subsidiaries operating in Australia, APRA intends to accept the IRB and other advanced approaches for determining the subsidiary's regulatory capital where these are adopted globally by the parent bank and approved by the home regulator. However, APRA reserves the right to vary the minimum capital ratio of foreign bank subsidiaries where it sees this as justified for prudential reasons or where there are potential competitiveness issues compared to local ADIs.

Credit Unions and Building Societies

Credit unions and building societies will be expected to adopt the standardised approach to credit risk and one of the simpler approaches to operational risk as discussed above. APRA intends to simplify the standardised approaches in line with the flexibility given to regulators under Basel II to avoid unnecessary complexity and cost in the less sophisticated approaches. APRA will be circulating a discussion paper on this approach later this year.

Revised Prudential Standards

APRA will be revising the existing ADI Prudential Standards and introducing new standards to incorporate the changes arising from the new Accord. A final version of the new Accord is expected by late 2003, with implementation of the new framework both in Australia and overseas envisaged by year-end 2006. It is currently proposed that draft Australian standards will be released for comment in the first quarter of 2004.

Generally, APRA intends to conform wherever possible to the international consensus on the new Accord, but will amend components when it sees this as necessary to reflect the unique circumstances in Australia. The new Accord does allow flexibility in approach in many areas to allow regulators to "fine-tune" certain requirements.