



**APRA'S BASEL III IMPLEMENTATION
INTRODUCTORY REMARKS**

JOHN F LAKER

**Chairman
Australian Prudential Regulation Authority**

***APRA Finsia Workshop
Sydney***

23 November 2011

APRA'S BASEL III IMPLEMENTATION

Introduction

This is the second occasion on which APRA and Finsia have joined forces to host a workshop on the new global capital and liquidity framework for banking institutions developed by the Basel Committee on Banking Supervision, and now known simply as 'Basel III'. We in APRA are pleased to renew the collaboration. And if the size of today's attendance is any indication, the topic continues to attract considerable interest.

Our first collaboration, in September 2010, addressed the proposed Basel III reforms on which, at that point, the Basel Committee had reached broad agreement. Since that workshop:

- the Basel Committee has released the detailed 'rules text' for the new global capital and liquidity framework, which incorporates certain concessional treatments not foreshadowed in the earlier proposals;
- the Financial Stability Board has released for consultation a set of proposals to reduce the risks posed by systemically important financial institutions and has published a list of about 30 global systemically important banks (G-SIBs), to which a capital surcharge over the Basel III minimum requirements would apply. No Australian bank is on that list and this topic is not one for today's conference; and
- APRA has released its proposals for the implementation of the Basel III capital reforms (in September) and liquidity reforms (in November).

Those of you who attended the first workshop may well leave here with a sense of *déjà vu*. That should not be a surprise. As we have been saying for some time now, APRA has been actively involved in developing these global reforms and it fully supports their implementation in Australia. There are points of departure from the Basel III reforms, clearly set out in our discussion papers, where APRA proposes to exercise national supervisory discretion or where clarifications are required for Australian circumstances. Otherwise, our proposals envisage what I described to the Finsia Financial Services Conference recently as a 'fairly straight-down-the-line approach' to the implementation of Basel III in Australia.

Of course, that will not stop analysts and others pouring over the details of our proposals looking for the devil. We welcome that close scrutiny, but we are confident that devil worshippers will be disappointed!

The Basel III reforms

The Basel III **capital reforms** are a comprehensive package of measures designed to raise the quality and minimum required level of capital in internationally active banks, promote the build-up of capital buffers and establish a back-up leverage ratio. Common equity will play a much more significant role in regulatory capital. As we announced, APRA is proposing to adopt the Basel III definition of regulatory capital, the minimum requirements for the different tiers of capital, and the stricter eligibility criteria for capital instruments. APRA is also proposing to adopt the Basel III regulatory adjustments to capital that are specified as minimum requirements, with only minor exceptions. APRA is also proposing to implement

the new capital buffers regime and the leverage ratio in line with the Basel III rules text.

However, we are not proposing to adopt the concessional treatments available to national supervisors that allow limited recognition of certain items in calculating Common Equity Tier 1. Our in-principle reasons for maintaining the *status quo* were set out in my recent remarks to the Finsia Financial Services Conference, and Mr Littrell will take you through some preliminary figuring on the impact of our approach.

In short, we are proposing to maintain a more conservative approach to capital than the Basel III minimum requirements. This should be no surprise either. APRA's regulatory framework is now widely acknowledged as an important contributing factor in the relative success of our banking institutions in negotiating the global financial crisis to this point. The most recent acknowledgements were by the Financial Stability Board (FSB) in its Peer Review of Australia (September 2011) and by the International Monetary Fund (IMF) in its 2011 Article IV Consultation with Australia (October 2011). And as both the FSB and IMF noted, one of the hallmarks of our regulatory framework has been our more conservative approach to the definition and composition of capital compared to many of our counterparts. The Basel III capital reforms, which aim to promote greater international consistency of capital requirements, will see our counterparts closing the gap with APRA. Even so, it would be perverse for APRA to accept a lower common denominator and relax a conservative stance that has served Australia well before and during the crisis.

And APRA does not have a mortgage on conservatism. Over the past year or so:

- in Switzerland, a committee of experts has recommended (October 2010) that, to deal with the 'too big to fail' issue, the two major Swiss banks should have a capital requirement of 19 per cent, at least 10 per cent of which is to be Common Equity Tier 1 and the remainder may come from contingent convertible instruments or CoCos;
- in Singapore, the Monetary Authority of Singapore announced (June 2011) that Singapore-incorporated banks will be required to meet a Common Equity Tier 1 ratio, including the capital conservation buffer, of nine per cent, higher than the comparable Basel III minimum requirement of seven per cent;
- in the United Kingdom, the final report (September 2011) of the Independent Commission on Banking, chaired by Sir John Vickers, has recommended a structural separation of retail and investment banking for UK banks and a minimum Common Equity Tier 1 capital requirement of 10 per cent for the ring-fenced retail bank; and
- in Europe, the Euro Summit in October 2011 agreed on a comprehensive set of measures to, *inter alia*, increase the Core Tier 1 position of European banks to nine per cent by the end of June 2012.

The Basel III **liquidity reforms** involve a strengthening of governance and risk management of liquidity risks in banking institutions – the so-called qualitative requirements – and two new global liquidity standards. These quantitative requirements are a short-term Liquidity Coverage Ratio to ensure that banking institutions have adequate funding liquidity to survive one month of stressed

funding conditions, and a longer-term Net Stable Funding Ratio to address mismatches between the maturity of a bank's assets and that of its liabilities.

APRA is proposing that all authorised deposit-taking institutions (ADIs) in Australia meet the enhanced qualitative requirements, in a way that is commensurate with the nature, scale and complexity of the institution. However, only the larger, more complex ADIs will need to meet the two new quantitative requirements. In this area, APRA is proposing to introduce the Basel III rules text with only minor modifications, related either to the exercise of supervisory discretion or where clarification is required for Australian circumstances. One such circumstance we have recognised, where Australia is unusual internationally, is the volume of retirement savings managed through self-managed superannuation funds.

The major circumstance, of course, that distinguishes Australia from most other jurisdictions is the shortage in our domestic markets of high-quality liquid assets that would enable ADIs to meet their LCR requirement. The Basel III liquidity framework incorporates scope for alternative treatments and APRA and the Reserve Bank of Australia (RBA) have developed an arrangement – a secured committed liquidity facility – that is intended to cover an ADI's LCR shortfall. I am pleased that Dr Debelle from the RBA has joined the panel today to explain the workings of this facility.

Before turning to our panellists and the details of APRA's implementation of the Basel III reforms, I would like to comment on two particular aspects of the reforms that will no doubt come up in discussions this morning. One aspect that is clearly important is how the impact of the Basel III reforms might be assessed. The second aspect is APRA's proposed transition timetable, which has provoked some curious responses.

Assessing the impact of Basel III

Before it finalises its Basel III proposals, APRA is required under Government policy to prepare a Regulation Impact Statement that assesses costs and benefits. To this end, we have invited interested parties to provide information on the compliance impact. The larger ADIs have already provided extensive input into the Quantitative Impact Studies (QISs) carried out by the Basel Committee, and Mr Littrell will share some of the QIS findings with you. Until the consultation process has been completed and more data received, it would be premature for APRA to rehearse the Regulation Impact Statement, although it has been our strong view that the Basel III reforms will be of significant benefit to Australia.

Underpinning this view is the work that has been undertaken by the Basel Committee itself to analyse the long-term economic impact of the Basel III reforms. The analysis was not used to calibrate particular capital and liquidity requirements – there was no single model that could capture all the influences and mechanisms at work – but to get an understanding of the relative magnitude of the macroeconomic benefits and costs of the reforms. The analysis highlights the importance of distinguishing between the costs to banking institutions of holding higher levels of capital and liquidity, which are largely private costs, and the economic benefits of a safer global banking system that would be less prone to financial crisis. These benefits will accrue as private benefits to the shareholders of banking institutions; they will also accrue as public benefits to the real economy and taxpayers. Australia has been spared the worst fall-out from the global financial crisis but it is sobering that, elsewhere, temporary support for the global

banking system during the crisis is estimated to have peaked at around a quarter of global GDP.

The Basel Committee's analysis brought together experts from central banks, regulatory agencies and international institutions and it also drew on a variety of methodologies and models. It is by no means the final word on this complex subject – and the Basel Committee's conclusions on both the transitional and long-term impacts of the reforms have been challenged by industry – but it is the most comprehensive analysis undertaken to date.

This workshop is not the occasion for modelling pyrotechnics. What I would briefly like to do, however, is share with you the intuition behind the Basel Committee's analysis.

There were five main steps involved in the Basel Committee's assessment of the long-term net benefits of the Basel III reforms.

The first step was to calculate how much economic output would increase if the frequency and severity of banking crises could be reduced. Historical experience across countries and time shows that banking crises occur once every 20 to 25 years and that the losses in economic output during a crisis and in subsequent years are substantial. Some of those losses may be permanent. Figuring by the Bank of England put the global output losses from the current global financial crisis at a minimum of 90 per cent of 2009 world GDP and the figure would be much higher if those losses turn out to be permanent. To state the obvious, then, measures to reduce the probability of banking crises would have a substantial pay off. Fortunately, Australia has had little experience of banking crises in the post-war era and only the period of major increases in loan write-offs by banks in the late 1980s and early 1990s features as a crisis episode in one study, but not in others.

The second step was to estimate how much an increase in capital and liquidity requirements can reduce the probability of a banking crisis. This is a complex task, but the evidence does suggest that higher capital and liquidity requirements can significantly reduce this probability. It also suggests that the incremental benefit of higher capital and liquidity requirements declines as a banking system becomes better capitalised and moves further away from insolvency. This seems very plausible.

The third step was to evaluate whether higher capital and liquidity requirements might have other positive benefits. One benefit could be a reduction in the severity of banking crises. Intuitively, higher aggregate levels of capital and liquidity should help insulate strong banking institutions from the strains faced by weaker ones. Another benefit could be a reduction in the amplitude of business cycles. Here, the intuition is that higher capital requirements allow banking institutions to absorb losses in downturns and restrain lending in a boom, thereby smoothing the supply of credit over the cycle. Though there was some supporting evidence on both these benefits, the Basel Committee did not find it sufficiently compelling for inclusion in its overall evaluation.

The fourth and critical step was to assess the long-run economic costs of higher capital and liquidity requirements. In the Basel Committee's analysis, higher requirements are assumed to increase the cost of bank credit as banking institutions seek to recover the loss in net income resulting from the substitution of debt with more expensive equity, and from changing their funding profiles. The higher cost of bank credit lowers investment and consumption and output falls as a

consequence. This fall in output represents the economic costs of the Basel III reforms.

The Basel Committee made two very conservative assumptions in this fourth step. It assumed, firstly, that the higher funding costs are fully recovered exclusively by raising lending rates. Secondly, it assumed that the costs of equity and debt are not affected by the lower riskiness of the banking institution that would follow from its stronger capital and liquidity position. These two assumptions obviously can be challenged. Banking institutions can offset the loss of net income from higher capital and liquidity requirements by means other than increasing their lending rates, such as increasing efficiency or reducing operating costs. And in the Modigliani-Miller world, the disciplining effect of debt holders should ensure that the cost of capital and debt both decline as a banking institution reduces its leverage and requires a lower risk premium. This powerful result from modern finance theory, which was also evident in some empirical studies, tends to get lost in industry complaints, here and globally, that higher capital ratios make banking institutions somehow 'less competitive' and their shareholders poorer.

The final step was to bring the analysis of economic benefits and costs together. Work of this complexity obviously carries a number of caveats. For all the caveats, the Basel Committee's conclusion is a strong one: '... in terms of the impact on output there is considerable room to tighten capital and liquidity requirements while still achieving positive net benefits.'

In short, the Basel III capital and liquidity framework will result in a safer global banking system and, over time, a higher level of global output. Since Australian banking institutions raise funds in global capital and funding markets, they will be beneficiaries of this enhanced safety and the accompanying higher level of investor confidence in banking institutions. Greater safety is a compelling reason for Australia, too, to be counted 'in' on the Basel III reforms.

APRA's proposed transition timetable

The Basel Committee has set out detailed transitional arrangements for implementing the new global capital and liquidity framework. APRA has announced that it intends to follow this internationally agreed timetable for certain aspects of the capital reforms and for the quantitative requirements of the liquidity reforms. However, we have proposed an accelerated timetable of 1 January 2013 for introducing the revised Basel III minimum requirements for Common Equity Tier 1 (after deductions) and 1 January 2016 for introducing the capital conservation buffer.

This accelerated timetable is a vote of confidence, on APRA's part, in the strength of the Australian banking system. However, not everyone saw it that way.

Let me offer three brief points on our proposed transition timetable.

Firstly, we need to remember that the Basel Committee's timetable is a minimum timetable that has needed to accommodate the different circumstances of national banking systems, some of which have been in parlous condition. The Basel Committee has stated explicitly, however, that '...national authorities have the discretion to impose shorter transition periods and should do so where appropriate.' Australia obviously fits in the 'yes we can' category.

Secondly, other supervisory agencies – in Singapore, Canada and New Zealand, for example – have also announced accelerated implementation timetables. We are not alone. And the Euro Summit in October has set a yet more aggressive timetable for European banks.

Thirdly, and most tellingly, the 1 January 2013 target is not a ‘stretch’ target for the ADI industry. It is not really a target at all but a road sign that can only be viewed in the rear-vision mirror. As Mr Littrell will show, ADIs in Australia have already passed it. The 1 January 2016 target will require larger capital levels on the part of a number of ADIs but the target is readily attainable, if current industry profitability is maintained.

There is a hint in some reactions that APRA should ‘hedge its bets’ on the Basel III timetable because of market scepticism about the Basel III process in some other jurisdictions. Let me repeat what I told the Finsia Financial Services Conference last month: nothing in APRA’s international engagement suggests to us any weakening in the resolve of global policymakers, or members of the Basel Committee, to stay the course. And let me add one final point. Surely, given the recurring global market turbulence, nothing could be more positive for the competitive standing of ADIs in Australia, or for investor confidence in these institutions, than being early in displaying the Basel III equivalent of the Heart Foundation’s Tick Approval for the health of their capital position.

Mr Littrell will now take you through our Basel III proposals in more detail.