APRA'S REGULATORY PRIORITIES – AN UPDATE

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Finsia Financial Services Conference
Sydney

25 October 2011

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Introduction

A year ago, when I spoke at this same Finsia Financial Services Conference, the course of global regulatory reform of banking systems had been largely set and the core elements were firming up. And the environment for implementing reform was becoming more supportive, globally and in Australia. The risk was that improving times, the sense that the worst of the global financial crisis was behind us, would undermine the momentum behind the ambitious global reform agenda that the Leaders of the G-20 had been pursuing.

How that situation has changed! Over recent months, concerns about public finances in Europe and the United States, and about the sovereign debt exposures of European banks, have led to renewed bouts of global market turbulence and growing pessimism about global growth. We have entered what the International Monetary Fund has described as a 'dangerous new phase' of the crisis.

This is a more challenging environment for global regulatory reform. Financial institutions will be tempted to argue — some already are — that the global reform agenda should be delayed. That it is too demanding. This agenda, you will recall, is aimed at promoting a more resilient global banking system. One that, as a minimum, has more robust capital and liquidity buffers to enable banks to withstand the very shocks that many are again facing. However, nothing in APRA's international engagement suggests to us any weakening in the resolve of global policymakers to stay the course. On the contrary. Events have demonstrated that pre-crisis levels of capital and liquidity were clearly inadequate and it is simply not conceivable that policymakers will relent on reform and acquiesce in the *status quo*. And market dynamics are reinforcing reform efforts. Now that the regulatory bar has been raised on minimum capital and liquidity requirements, markets are pushing global banks to demonstrate that they will be able to clear the bar, and sooner rather than later.

My starting point today, therefore, is that APRA will not be running up a 'go slow' flag on the prudential policy initiatives it has under way in banking, or in the other industries it regulates.

My remarks will focus on two of the core elements of the global reform agenda that are shaping our policy and supervisory approach. The first is the new global regime for bank capital and liquidity, known as Basel III, and now in the implementation phase. The second is the emerging policy framework for reducing the risks posed by systemically important financial institutions. APRA's particular interest here is an initiative called the 'living will'. There is a third core element of the G-20 agenda that is now receiving the attention it is due — namely, more intensive and effective prudential oversight and supervision. As global policymakers have acknowledged, stronger regulations are only part of a comprehensive response to the crisis; ensuring supervisory agencies have both the ability and the willingness to act is every bit as important. However, that is the subject for another time.

Global capital and liquidity reforms

The new Basel III framework aims to raise the quality, quantity and international consistency of capital and liquidity for internationally active banks. The framework has been developed by the Basel Committee on Banking Supervision, of

which APRA and the Reserve Bank of Australia are members, and the detailed 'rules text' was released in December 2010.

Since APRA and Finsia are co-hosting an industry conference on the Basel III reforms on 23 November in Sydney, I can leave the details of the reforms until then. What I would like to do is explain the general approach APRA is proposing to take in implementing these reforms.

Let me start with capital. Step one in the implementation process is a set of measures to improve the risk coverage of the Basel capital framework, dealing with trading activities, securitisations, exposures to off-balance sheet vehicles and counterparty credit exposures. These so-called Basel II.5 measures have been finalised and will come into effect in Australia at the beginning of 2012. Step two is the more comprehensive Basel III package, which comes into effect in stages from the beginning of 2013. This package includes measures to raise the quality and minimum required levels of capital, promote the build-up of capital buffers and establish a back-up leverage ratio. There are two new regulatory capital buffers. One is a conservation buffer above the regulatory minimum capital requirement that is intended to be utilised in periods of stress, subject to restrictions on distributions. The other is a countercyclical buffer that will come into effect when excessive credit growth and other indicators point to a build-up in systemic risk.

Central to the package is a new definition of regulatory capital that gives greater weight to common equity, the highest quality form of capital. Common equity has become the new 'gold standard' for bank capital.

APRA's proposals for implementing the Basel III capital reforms have now been released. 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. This broad alignment of approaches will require APRA to tighten up in some areas where we are less onerous than Basel III and, in the interests of international consistency, to take a less conservative approach than hitherto in other areas. APRA is also proposing to implement the new capital buffers regime and the leverage ratio in line with the Basel III rules text. All in all, a fairly straight-down-the-line approach to the implementation of Basel III.

But not complete alignment. There are areas where Basel III provides national supervisors a discretion to allow limited recognition of certain items in calculating Common Equity Tier 1 — in effect, a concessional treatment. Since we believe there are strong in-principle reasons to continue our current approach to these items, we do not see these concessions as necessary or appropriate. Our approach is, however, likely to be a point of contention in our industry consultations, so it may be worth setting out our reasons in a little detail.

The first principle that underpins our proposed approach is that assets that rely on the future profitability of a banking institution to be realised, or that are highly uncertain in value, cannot be included in the calculation of capital. This is one instance where accounting standards, based upon the viewpoint of an equity investor in a going concern, provide a different perspective from that taken by a prudential regulator, which tends to take a creditor's view of an entity in a stressed situation.

This principle is relevant to the Basel III treatment of deferred tax assets, which allows a split treatment. Deferred tax assets that rely on the future profitability of the banking institution to be realised are to be deducted in the calculation of Common Equity Tier 1, but deferred tax assets relating to 'temporary' differences may be eligible for concessional treatment. Such assets arise when the institution's future income will be sheltered from some income tax due to assets held on the balance sheet but not currently available for use. Loan loss provisions are a common source of such accounting assets. APRA proposes to adopt the standard treatment of deferred tax assets, i.e. a full deduction. In Australia, deferred tax assets, whatever their origin, rely on the future profitability of the banking institution to be realised, and there can be no certainty that an institution can generate the necessary taxable profits to monetise these assets. At a point of failure, when depositors need the greatest protection, these assets may well be worthless.

The second principle is that capital cannot be used more than once in a financial system to absorb losses. That is, there should be no double-gearing of capital, or what is sometimes called double duty or double leverage of capital. Double-gearing arises where a quantity of capital is being given credit for supporting risks in one institution but, at the same time, is being given credit for supporting risks in another institution. The existence of double-gearing can create a potentially serious problem of financial contagion when a loss of capital in one financial institution leads directly to the loss of regulatory capital in a banking institution that has invested that capital.

This principle is relevant to the Basel III treatment of significant investments in the common shares of non-consolidated financial institutions. Basel III requires such investments to be fully deducted from capital when they exceed 10 per cent of Common Equity Tier 1, but allows national supervisors to adopt an alternative, concessional treatment for amounts below this threshold. Again, APRA proposes to stick simply with the standard treatment of full deduction.

APRA's principles in these two areas are long-standing; indeed they well pre-date APRA itself. But they are not unique to APRA. They are fundamental principles in the Basel capital framework itself, set out clearly in the original Basel III proposals released in July 2009. The concessional treatment came later in the consultation process, and was explained by the Basel Committee as a recognition that certain deductions could have potentially adverse consequences for some existing business models and provisioning practices. We did not see this explanation as relevant to Australian circumstances.

If common equity is the new gold standard for bank capital, the gold held by ADIs in Australia will be 24 carat!

That may not always be obvious at first blush. APRA's proposed approach will tend to produce lower 'headline' capital ratios for a given balance sheet than will be produced in jurisdictions where supervisors choose to exercise the Basel III concessions. Australian banks argue that, as a consequence, they will face difficulties in explaining their financial strength to international investors, who may not understand APRA's approach. We acknowledge the concern but we also note that it is easily overstated. (And, under Basel III, differences in headline ratios will be much lower than is the case at present.)

Clearly, the credit rating agencies understand and respect our prudential regime, since they keep our major banks in very select company. Clearly, too, the astute

investor understands, since equity issues by major banks after the crisis erupted were oversubscribed. And even in the current period of market turbulence, Australian banks have had better access to international investors than many of their global peers. The concern is really about the so-called 'lazy' analyst, simply comparing headline ratios without awareness of the 'apples and oranges' comparison involved. The answer to concerns about the lazy analyst is improved transparency of bank capital ratios, through greater disclosure. To this end, the Basel Committee is developing a disclosure template that, once introduced around the globe, will help Australian banks demonstrate the impact of APRA's more conservative requirements on their headline capital ratios.

Basel III liquidity reforms

Let me turn now to the Basel III liquidity framework, which will begin to come into effect from 1 January 2015. This framework seeks to promote stronger liquidity buffers and more stable sources of funding through two new global liquidity standards — a 30-day Liquidity Coverage Ratio to address an acute liquidity stress scenario, and a Net Stable Funding Ratio to promote longer-term resilience.

As has been well canvassed, ADIs in Australia could not meet the Liquidity Coverage Ratio as originally proposed because the volume of high-quality liquid assets (particularly government securities) for inclusion in liquidity buffers is, for the best of reasons, in short supply in Australia. These circumstances have been recognised by the Basel Committee, and APRA and the Reserve Bank of Australia (RBA) have worked closely with fellow Committee members to agree an alternative treatment that meets the intent of the global reforms. Under that treatment, an ADI will be able to establish a committed secured liquidity facility with the RBA, sufficient in size to cover any shortfall between the ADI's holdings of high-quality liquid assets and the Liquidity Coverage Ratio requirements. For its part, APRA will require participating ADIs to demonstrate that they have taken all reasonable steps towards meeting their liquidity requirements through their own balance sheet management, before relying on the RBA facility.

APRA's proposals for implementing the Basel III liquidity reforms, and details on the RBA facility, will be released shortly and there is nothing more I can say today.

Living wills

The second of the core elements of the global reform agenda is the emerging policy framework for reducing risks posed by systemically important financial institutions (SIFIs).

One of the major themes to emerge from the crisis is the need to ensure that such institutions have the capacity to recover from a destabilising event or that they can be resolved cost-effectively if recovery is not possible. This theme is encapsulated in the term 'living will', a new term in the lexicon of prudential supervisors. Work to date internationally on living wills, under the auspices of the Basel Committee and the Financial Stability Board, has concentrated on systemically important financial institutions but it has much wider relevance.

A living will refers to two separate but related matters: 'recovery plans' and 'resolution plans'. Recovery planning focuses on measures that would enable a financial institution to survive a destabilising event, such as through its strategies for raising additional capital, accessing liquidity or disposing of non-core business. Resolution planning focuses on measures that would enable a cost-effective

resolution of the institution by the authorities where recovery is not possible, such as pre-positioning for different forms of resolution and simplifying complex group structures to facilitate resolution. Recovery and resolution planning are connected in that both deal with distress events that threaten the viability of a financial institution and both seek to achieve a resolution that minimises adverse systemic impact, at the lowest risk to the taxpayer. However, recovery and resolution planning address some quite different issues and the complexities and challenges vary with each.

The Basel Committee, through its Cross-border Bank Resolution Group (a group in which APRA participates), published recommendations on recovery and resolution planning in March 2010. The Group sees recovery planning as a mechanism to facilitate recovery from financial shocks without the need to rely on taxpayer funding. As a means of bringing greater discipline to the boards of banks and other financial institutions by having them focus on a matter — survival — to which they may otherwise pay too little attention given their more immediate responsibilities. Hence, recovery planning has a broader purpose in reinforcing sound governance and risk management, and in attenuating moral hazard risks. The Group sees resolution planning as an essential pre-requisite for resolution when the authorities need to step in. Resolving the acute distress of a complex financial institution requires careful planning and pre-positioning, particularly if the aim is to minimise taxpayer costs and to focus resolution on just those parts of a financial institution that are regarded as being important for financial stability.

The Financial Stability Board released its Consultative Document, *Effective Resolution of Systemically Important Financial Institutions*, in July 2011. This provides guidance for the effective resolution of financial institution distress, including a proposed framework for and contents of recovery and resolution plans. These will be mandatory for global SIFIs (G-SIFIs) but there is an emerging expectation that this framework would apply to all SIFIs and potentially to other banks and financial institutions, with appropriate modifications.

In its guidance, the Financial Stability Board states that recovery and resolution plans should be based on the specific characteristics of the institution, that the stress scenarios should be sufficiently severe, and the options for recovery and resolution measures should be concrete and practical. A suggested list of elements for recovery plans is also set out.

This is the broad international context for APRA's work on living wills. APRA will, of course, want to ensure that the arrangements for recovery and resolution planning are fit for purpose for Australia; they need to complement our existing supervisory philosophy and framework and be tailored to the particular characteristics of the Australian financial system. As with other areas of prudential regulation, we want to avoid a 'one size fits all' approach. We will therefore develop the living will arrangements to suit Australian conditions and, as always, with a clear recognition of the need to strike a sensible balance between systemic soundness, system efficiency and avoiding excessive compliance costs for our regulated institutions.

Our starting point on living wills has been on recovery planning in the authorised deposit-taking (ADI) industry. We see recovery planning as a core element in crisis resolution and we will expect ADIs to make it a core feature of their governance and risk management frameworks. We will be expecting engagement by Boards and senior management in the development and ongoing review of recovery plans

and in ensuring that key elements of recovery plans are reflected in their corporate structures, business plans, capital settings and risk parameters.

In this context, earlier this year APRA established a pilot program on recovery planning for a number of the larger ADIs. This will require the ADIs to prepare a comprehensive recovery plan that sets out the specific actions they would take to restore themselves to a sound financial condition in the context of an assumed scenario involving a major depletion of capital and associated liquidity pressures. Draft recovery plans will be required by the end of 2011 and finalised plans, signed-off by the board of each ADI, will be required by June 2012. Consistent with the approach taken internationally, we have asked that recovery plans provide a 'menu' of actions that could be deployed, focusing on the actions that could make a material difference to capital and funding. We have also emphasised that recovery actions should be credible and realistic, with sufficient detail to give boards and supervisors confidence that the actions could be implemented in practice. Board ownership is essential.

Recovery plans are expected to cover the following areas:

- an overview of the legal and operational business structure;
- analysis of the separability of core and non-core business functions;
- a menu of credible recovery actions, with a financial, operational and strategic assessment and financial projections of the cumulative impact of these actions;
- non-financial actions, including a media and communications strategy; and
- roles and responsibilities for developing, reviewing and activating the plan.

Although the pilot program is limited to the larger ADIs, APRA intends to extend its recovery planning program to a wider set of ADIs in 2012/13 once the results of the pilot program become clearer.

Recovery planning is also likely to be extended to the larger general insurance and life insurance companies in due course, modified to suit the nature of their business. The objective of recovery planning for insurance companies is much the same as for ADIs and it is just as important that insurance companies have robust recovery plans in place. However, the details of recovery planning for insurance companies will be different in some key respects than for ADIs, reflecting the different nature of their business, their liability structure and their asset profile.

Although we are at an early stage in our work on living wills, we do not view them as a 'nine day wonder' — that is, something that has gained prominence following the global financial crisis, only to fade into obscurity when the global financial system eventually returns to stability. Rather, we intend to make recovery plans a permanent feature of APRA's supervision. It is likely that the results of recovery planning will have implications for a number of other elements of the supervisory process, including stress testing, assessment of risk management and the calibration of capital requirements. We therefore view recovery planning through a broader lens than just crisis resolution. It provides a means by which Boards as well as APRA can further assess the adequacy of existing risk management frameworks, business structures, separation arrangements, intra-group contagion and capital adequacy.

On resolution planning, let me note that APRA will also be undertaking an assessment of institution-specific resolution planning as part of the living will work program, but only after we are satisfied that substantial progress has been made on recovery planning. We are also mindful that resolution planning entails complexities and potential costs that go beyond those involved in recovery planning, particularly so if it extended to pre-positioning requirements for different forms of resolution, such as separability of business functions. We will be proceeding carefully down this path.

Other regulatory priorities

No update on APRA's prudential policy initiatives would be complete without reference to two other major initiatives that have their origins in lessons from the crisis, but do not form part of the global reform agenda.

The first is APRA's review of the capital standards for the general insurance and life insurance industries. APRA is proposing to make the capital standards more risk-sensitive, improve their alignment across regulated industries where appropriate, and consider the standards in the light of international developments. This review has proven timely, given the recurring episodes of equity market volatility and, for general insurers, the recent natural disasters.

APRA has been consulting extensively throughout this review. We are currently analysing submissions on a revised set of proposals and from a second quantitative impact study, and there will be a further round of consultations before new prudential standards are finalised. These are expected to be released in the first half of 2012, to take effect from 1 January 2013.

The second major initiative is our proposed prudential framework for consolidated groups. The severe contagion problems that required the public rescue of a global insurance group highlighted the need for supervisors to be able to take a group-wide view of their regulated institutions and to understand the full range of risks that arise from group membership. Again, our proposals have been subject to consultation and qualitative impact analysis, and we hope to release draft conglomerate prudential standards in the first half of 2012. Obviously, this work needs to be appropriately sequenced with our Basel III initiatives and our review of capital standards in insurance.

Finally, a new and important initiative arising out of the Government's Stronger Super reforms. The Government has announced that it will release draft legislation to enable APRA to make prudential standards for superannuation and, last month, we released a discussion paper introducing our proposals in this area. The paper sets out the range of topics to be covered and the key requirements we expect to include in each standard.

The introduction of prudential standards for the superannuation industry will be an important step forward in harmonising the prudential framework across the industries we regulate. We have had prudential standards for ADIs since 2000 (and prudential statements for banks issued by the Reserve Bank of Australia go back to the mid-1980s), for general insurers since 2002 and life insurers since 2006. Our experience is that the principles-based approach that we promote in our prudential standards works well in these industries and provides for robust prudential supervision. We have no reason to doubt that it will be any different for superannuation.

In determining prudential requirements, APRA recognises that the nature, size and complexity of institutions vary across any industry. Prudential standards allow for appropriate flexibility, avoiding a 'one-size-fits all' approach. APRA's emphasis is on sound prudential outcomes, without specifying or prescribing the exact manner in which those outcomes are to be achieved.

APRA expects that draft prudential standards will be released for consultation in early 2012. Final prudential standards are expected to be released later in 2012, subject to the passage of legislation.

In addition to developing prudential standards, APRA will also be implementing other elements of the Stronger Super reforms. In particular, APRA is developing a revised data collection for the superannuation industry to update our current collection and expand it to include items coming out of Stronger Super, such as data on MySuper products. Also, APRA is developing a process to authorise trustees to offer MySuper products and we expect this to be in place well before the 1 July 2013 start-date for these products.

All in all, a very busy time on the prudential policy front and our policy resources will be fully stretched for the next twelve to eighteen months. After that, we hope to draw breath!