



Response to Submissions

Implementation of the Basel II Capital Framework

5. Basel II Prudential Standards

30 November 2007

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Preamble

In 2003, APRA announced its intention to implement a new global capital adequacy regime, known as the Basel II Capital Framework (the Framework), in Australia. The Framework will come into effect from 1 January 2008 through APRA's prudential standards, and will apply to all authorised deposit-taking institutions (ADIs) – banks, building societies and credit unions.

Since 2005, APRA has progressively released its proposed approach to the implementation of the Framework through releases of draft prudential standards and discussion papers for comment. In many cases, a response paper and a revised draft prudential standard, taking into account issues raised in submissions, have been released for further industry consultation. APRA has also separately consulted with advanced ADIs that will be impacted by transitional arrangements.

This paper summarises APRA's responses to submissions on the final drafts of its Basel II prudential standards. The full suite of prudential standards that comes into effect on 1 January 2008, and accompanying prudential practice guides, is:

Capital adequacy

- *APS 110 Capital Adequacy;*
- *APS 111 Capital Adequacy: Measurement of Capital;*

Standardised approaches to credit and operational risks

- *APS 112 Capital Adequacy: Standardised Approach to Credit Risk and Prudential Practice Guide APG 112;*
- *APS 114 Capital Adequacy: Standardised Approach to Operational Risk and Prudential Practice Guide APG 114;*

Advanced approaches to credit and operational risks and interest rate risk in the banking book

- *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk and Prudential Practice Guide APG 113;*
- *APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk and Prudential Practice Guide APG 115;*
- *APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs) and Prudential Practice Guide APG 117;*

Market risk

- *APS 116 Capital Adequacy: Market Risk and Prudential Practice Guide APG 116;*

Securitisation

- *APS 120 Securitisation and Prudential Practice Guide APG 120;*

Public disclosure of prudential information

- *APS 330 Capital Adequacy: Public Disclosure of Prudential Information; and*

Transition standard

- *APS 150 Capital Adequacy: Basel II Transition (Advanced ADIs).*

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Chapter 1 – Capital adequacy and measurement of capital

Review of submissions

There were 12 submissions on the final drafts of *Prudential Standards APS 110 Capital Adequacy* (APS 110) and *APS 111 Capital Adequacy: Measurement of Capital* (APS 111), released in July 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This chapter examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Capital support

Comments received and issues raised

A number of submissions raised concerns about the provisions on capital support and expressed the view that the principles were, in fact, quite prescriptive and would have the unintended effect of capturing instruments that are not capital support in either form or substance.

APRA's prudential approach

APRA remains of the view that capital support, whether to related or unrelated entities, needs to be appropriately recognised in the measurement of capital. APRA has, however, modified the provisions on capital support so they are more principles based and do not have unintended consequences, such as capturing legitimate instruments that do not act as forms of capital support.

Definition of equities

Comments received and issues raised

Some submissions raised questions about the definition of equity and other capital investments and sought clarity about the use of this term. Submissions also sought clarity on the treatment of units in unit trusts and whether deduction was required from capital.

APRA's prudential approach

For the purposes of clarity, APRA has applied a consistent approach to the definition of equity across the Basel II prudential standards. APRA has replaced the term 'equity' in APS 111 with 'equity exposures' and aligned the definition with that set out in *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113).

The treatment of holdings of units in trusts in APS 111 has also been clarified. Such units are to be treated in the same way as in APS 113 in determining whether they are equity or debt instruments.

Calculation of deductions and application of limits

Comments received and issues raised

Some submissions raised concerns that the introduction of the 50 per cent deduction of certain items from both Tier 1 capital and Tier 2 capital would reduce net Tier 1 capital and thereby further limit the amount of Total Tier 2 capital and Lower Tier 2 capital that an ADI is able to hold.

APRA's prudential approach

APRA has clarified in APS 111 that limits only apply once all deductions required in APS 111 have been made.

Criteria for Upper Tier 2 instruments

Comments received and issues raised

A few submissions raised concerns as to the practical effect of applying the criteria for eligible Upper Tier 2 capital instruments, which required issuers to have the right to waive any dividend or interest payments. The underlying principle is that Upper Tier 2 capital instruments should not pay dividends or interest if an issuer's profitability is not sufficient or its solvency would be affected by such payments.

APRA's prudential approach

APRA has amended APS 111 to make it clear that the ability to waive dividends or interest payments is linked to matters of profitability and solvency. In addition, issuers of Upper Tier 2 capital instruments are now required to satisfy themselves that there are reasonable grounds to believe that the limitation on payment of dividends and interest based on profitability will be binding on investors.

Treatment of lenders mortgage insurer (LMI) subsidiaries

Comments received and issues raised

Some submissions sought the same treatment of investments in LMI subsidiaries as applied to other forms of subsidiaries – for example, at Level 2, deduction of investments 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital instead of 100 per cent from Tier 1 capital.

APRA's prudential approach

APRA has clarified in APS 111 that investments in LMIs should be treated in the same way as investments in other insurance subsidiaries.

Additions and other changes

The final versions of APS 110 and 111 include the following additions and other changes:

- clarification of the application of the standards to authorised non-operating holding companies (NOHCs) where an ADI is a subsidiary of an authorised NOHC. In these cases, it is the responsibility of the authorised NOHC to ensure the requirements of the standard are complied with on a Level 2 basis; and
- introduction of the concept of a Prudential Capital Ratio (PCR). The PCR is the minimum risk-based capital ratio an ADI is required to maintain. The PCR is eight per cent of total risk-weighted assets, unless APRA determines a higher PCR.

Chapter 2 – Standardised approaches to credit and operational risks

2.1 Standardised approach to credit risk

Review of submissions

There were seven submissions on the final draft of *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112), released in July 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This section examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Definition of core market participants

Comments received and issues raised

APRA proposed a list of entities to be defined as 'core market participants' for the purpose of applying a zero haircut on repurchase and reverse repurchase agreements.

Submissions claimed that this definition was unnecessarily restrictive and argued for the inclusion of other entities.

APRA's prudential approach

APRA sees merit in this argument and has expanded the list of entities to include certain overseas governments and central banks and other entities. This revision is consistent with the Framework's intent and with the approach taken by overseas regulators.

Definition of equities

Comments received and issues raised

The final draft of APS 112 did not include a definition of the instruments to be included as equity exposures. Submissions requested clarification of the definition of equity exposures.

APRA's prudential approach

The regulatory capital treatment of equities is identical in both the standardised approach and the internal ratings-based approach (IRB) to credit risk, as set out in APS 113. Accordingly, equity exposures are defined identically in APS 112 and APS 113.

Revised definition of listed equities for risk-weighting purposes

Comments received and issues raised

In the final draft of APS 112, the category of equities was limited to equities that were included in the main indices of certain global stock exchanges. Submissions highlighted that this policy was more restrictive than the Framework and could raise potential home-host conflicts.

APRA's prudential approach

APRA sees merit in this argument. Accordingly, the final version of APS 112 defines equities to be all equities on a recognised exchange.

Credit derivatives and APRA pre-approval

Comments received and issues raised

In the final draft of APS 112, APRA proposed that an ADI seek APRA's prior written approval on the appropriate regulatory capital treatment for more complex credit derivatives that fall outside the scope of the prudential standard. Submissions noted that this proposal was not in line with APRA's approach for securitisation and market risk.

APRA's prudential approach

Consistent with APRA's commitment to a principles-based approach, APS 112 has been revised so that ADIs transacting more complex credit derivatives that fall outside the scope of APS 112 do not need to seek prior approval from APRA. However, prior to execution of the relevant credit derivative contract, the ADI must undertake in writing its assessment of the appropriate regulatory capital treatment for the transaction, and apply this treatment.

Additions and other changes

The final version of APS 112 includes the following additions and other changes:

- restructure of the standard to make it more principles-based and more succinct, and rationalisation of the number of attachments for ease of use; and
- introduction of an interim capital requirement for margin lending. A risk-weight of 20 per cent is to be applied to outstanding loans that are backed by listed instruments; otherwise exposures are to be treated as secured loans. APRA will be undertaking a further review of the capital treatment of margin lending.

2.2 Standardised approach to operational risk

Review of submissions

There were four submissions on the final draft of *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk (APS 114)*, released in July 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This section examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Intra-group dividends

Comments received and issues raised

In the final draft of APS 114, APRA proposed that intra-group dividends remain part of the income base for the 'all other activity' area.

Submissions again argued that the inclusion of intra-group dividends would penalise diversified ADIs by effectively double-counting the investment in non-consolidated subsidiaries for capital purposes.

APRA's prudential approach

In revisiting this issue, APRA has concluded that there is minimal operational risk associated with the receipt of 'genuine' dividends and dividend income can be received regardless of whether an ADI has any other dealings with the entity paying dividends. Accordingly, dividends may be excluded from the calculation of adjusted gross income.

List of items excluded from adjusted gross income calculation

Comments received and issues raised

The final draft of APS 114 listed items that may be excluded from the calculation of adjusted gross income.

Submissions argued that the list of income items should be extended to other income items with similar characteristics to those proposed for exclusion. Submissions also argued that extraordinary items be excluded from the adjusted gross income calculation.

APRA's prudential approach

APRA does not believe it is possible to have an exhaustive list of income items that may be excluded from the calculation of adjusted gross income. However, APRA acknowledges there may be compelling reasons why some other income items, including irregular items, may be on the list of excluded items. APRA has included guidance on adjusted gross income, including items that may be excluded from this calculation, in *Prudential Practice Guide APG 114 (APG 114)*.

Inclusion of cash holdings

Comments received and issues raised

The final draft of APS 114 included cash in the definition of loans and advances under the retail banking area of business.

Submissions argued that this approach was a divergence from the Framework and raised a concern about the omission of deposits from business line mapping. Under the Alternative Standardised Approach, deposits are included within the business lines that are subject to an operational risk charge on the basis of total assets.

APRA's prudential approach

APRA's view is that cash holdings (notes and coins) held by an ADI give rise to an operational risk that, in some cases, can be significant. Hence, there appear to be no valid reasons for its exclusion from the retail banking area of business.

Chapter 3 – Advanced approaches to credit and operational risks and interest rate risk in the banking book

3.1 Internal ratings-based (IRB) approach to credit risk

Review of submissions

There were six submissions on the final draft of APS 113, and accompanying *Prudential Practice Guide APG 113* (APG 113), released in June 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This section examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Definition of specialised lending (SL) exposures

Comments received and issues raised

Submissions argued that the inclusion of the characteristics that identify SL exposures in a prudential practice guide rather than a prudential standard adds ambiguity to the identification of these exposures.

APRA's prudential approach

APRA agrees that the identifying characteristics of SL exposures and the four sub-asset classes of SL should be moved to APS 113 from APG 113.

Application of the scaling factor

Comments received and issues raised

The Framework applies a scaling factor of 1.06 to risk-weighted assets under the IRB approach. Submissions requested clarification of the application of the scaling factor for exposures where an ADI does not use a modelling approach but uses simple supervisory risk-weights (which, at least currently, are identical in all cases to those used by non-IRB institutions under the standardised approach). Examples include the IRB treatment for fixed assets, equity holdings and the newly introduced approach for margin lending. Submissions argued that it was difficult to justify a higher IRB capital requirement for those exposures where there is no difference in the calculation approach compared with standardised institutions.

APRA's prudential approach

APRA agrees with this argument. APS 113 has been modified so that the scaling factor only applies to risk-weighted asset amounts that are derived from the IRB risk-weight functions. From time to time, additional modelling techniques may be recognised under the IRB approach; the application of the scaling factor to those approaches will be considered at such times.

Retail data retention requirements

Comments received and issues raised

The final draft of APS 113 (paragraph 58 of Attachment A) expanded the data required to be retained by IRB institutions relating to defaulted retail exposures compared with the Framework. Submissions argued that the additional data retention requirements were unnecessary and unduly onerous.

APRA's prudential approach

Following work undertaken as part of the IRB approval process, APRA now agrees that the additional data requirements are not needed and has reverted to the wording of the Framework.

Other changes

Other changes to APS 113 relate to the closure of several matters that remained outstanding following the release of the final draft in June 2007. Those changes comprise:

- incorporation of the Framework's provisions relating to recognition of netting;
- application to IRB institutions of the standardised treatment for margin lending exposures set out in APS 112; and
- given the difficulties in objectively rating related parties, application to IRB institutions of the standardised risk-weights set out in APS 112 to their related-party exposures. As these exposures will be eliminated from the calculation upon consolidation at Level 2, the standardised risk-weights are only applicable for determining an institution's Level 1 IRB capital requirement.

A further change to APS 113 expands the category of equity exposures eligible for a 300 per cent risk-weight from those included in the main indices of recognised stock exchanges to all equities listed on such exchanges. The new wording matches the Framework (a simple market-based approach for equity exposures), with a corresponding revision to APS 112.

Also relevant to IRB institutions is the additional guidance that has been provided in *Prudential Practice Guide APG 112* (APG 112) setting out APRA's long-standing advice relating to the timing of recognition of commitments for capital purposes.

Outstanding issues

As previously announced, inclusion in APS 113 of the Framework's proposals that would permit ADIs' own counterparty credit risk¹ estimates has been deferred into 2008. This deferral was undertaken in consultation with applicant institutions to expedite other aspects of the Framework of greater current relevance to both APRA and the institutions concerned. It was also in keeping with the development timetables of applicants.

3.2 Advanced measurement approaches (AMA) to operational risk

Review of submissions

There were five submissions on the final draft of *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* (APS 115), and accompanying *Prudential Practice Guide APG 115* (APG 115). Comments covered a range of issues including technical, drafting and interpretation issues. This section examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other discussion channels.

Material changes

Comments received and issues raised

The final draft of APS 115 proposed that any subsequent material changes to the key elements of the AMA require APRA's written approval prior to implementation.

Submissions requested guidance from APRA on what constitutes 'material changes' that would require APRA's prior approval.

APRA's prudential approach

APRA's view is that the determination of materiality remains the responsibility of the institution. However, for complex ADIs, it might be expected that a more regular and focused supervisory review approach could provide an early warning signal on issues of materiality.

APS 115 now explicitly states that APRA's prior written approval is required for any material changes to the operational risk measurement model and prior notification to APRA is required for material changes to other components of the operational risk management framework.

Conservatism

Comments received and issues raised

The final draft of APS 115 proposed that an ADI must be conservative in the modelling choices and assumptions used in its operational risk measurement model, giving consideration to the results of sensitivity analysis.

Submissions appreciated the conservatism requirements and recommended that further guidance be provided in relation to conservative modelling approaches.

APRA's prudential approach

APG 115 now has additional guidance outlining a framework for assessing model uncertainties consistent with the conservatism requirement in APS 115.

¹ Counterparty credit risk is defined as the risk that the counterparty to a transaction could default before the settlement of the transaction cash flows.

Prior period losses

Comments received and issues raised

The treatment of operational risk events that change an ADI's prior period financial performance has been a topic of discussion among global prudential regulators and industry.

Institutions discussed their practice relating to such operational risk events and noted some concerns that APRA's proposed guidance in APG 115 was beyond their definition of operational risk loss.

APRA's prudential approach

APRA considers that operational risk events that change an ADI's prior period financial performance are consistent with the scope of operational risk as defined in APS 115. APG 115 now includes additional guidance on the treatment of prior period losses and two broad examples of such operational risk events.

3.3 Interest rate risk in the banking book (IRRBB)

Review of submissions

There were five submissions on the final draft of *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (APS 117), and accompanying *Prudential Practice Guide APG 117* (APG 117), released in June 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This section examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Calculation basis

Comments received and issues raised

In the final draft of APS 117, APRA introduced an 'earnings offset' to the capital calculation for repricing and yield curve risk, designed to reflect the changes in earnings over the holding period arising from interest rate changes. The earnings offset had the same effect as allowing an 'investment term of capital' (iToC) based on a one-year moving average.

Submissions raised the following concerns about APRA's proposed approach:

- the earnings offset was inconsistent with bank practice, because it has the same effect as a one-year iToC, whereas an ADI would typically use a three- to five-year iToC in its own-purpose calculations; and
- assurance was sought that using an iToC different from one year in an ADI's own-purpose calculations would not be considered as a reason to fail the 'use test'.

APRA's prudential approach

The earnings offset is not intended to reflect current practices of ADIs but to incorporate into the capital measure the (usually mitigating) effect of changes in earnings over the holding period that would arise as a result of interest rate changes. APRA is satisfied that the earnings offset achieves this aim. The aim of most ADIs in using an iToC for their own-purpose calculations is quite different, so it is to be expected that the moving-average period used by ADIs in those calculations would differ from the period used in regulatory capital calculations.

APRA will not regard the use of an iToC other than one year for non-regulatory capital calculations as a reason for an ADI failing the use test. This is consistent with the approach for traded market risk where many ADIs use holding periods and/or confidence levels in non-regulatory capital calculations that differ from those used for regulatory capital.

Holding period

Comments received and issues raised

The final draft of APS 117 proposed that the non-traded interest rate risk capital requirement be based on a one-year holding period.

A number of submissions argued that a one-year holding period was too long, mostly repeating arguments raised earlier. New arguments raised were that:

- the inclusion of embedded gains and losses exacerbates the pro-cyclical nature of the IRRBB capital requirement. A related question asked was whether a model that incorporated some element of mean reversion could be used, noting that in some cases this would reduce the pro-cyclicality;
- a one-year holding period is inconsistent with requiring ADIs to hold capital for embedded gains and losses that is updated on a more regular basis than yearly; and
- there are technical difficulties of modelling risk over a one-year period, including the suggestion that a shorter holding period in combination with a multiplier might be considered. This has led APRA to analyse some different techniques.

APRA's prudential approach

APRA recognises that most market risk models, in common with most credit risk models, suffer from pro-cyclicality. APRA does not consider that this in itself is sufficient reason to either alter the holding period or to exclude embedded gains and losses. APRA has no objection to ADIs using models that incorporate mean reversion, provided they can substantiate the assumptions used and that the model is used consistently over time. APG 117 has been updated to reflect this view.

APRA does not accept the argument about inconsistency between the period for updating embedded gains and losses and the holding period. In general, there is no logical link between the projection period of a forecast and the frequency of updating that forecast.

APRA's analysis has indicated that a commonly used technique for measuring repricing and yield curve risk, which involves historical sampling from a set of overlapping one-year periods with start dates separated at daily intervals, suffers problems with statistical robustness caused by correlations between the observations. These problems appear to be greater than problems associated with alternative techniques and also have the disadvantage of biasing the risk estimate downwards (i.e. underestimating the capital requirement). Accordingly, APRA has indicated in APG 117 that it will be difficult for models based on this type of approach to meet the 'soundness test'.

On the other hand, APRA has decided that an approach to measuring repricing and yield curve risk based on calculating the risk over a shorter period than one year, and then scaling the capital estimate up to a one-year figure using a suitable factor (square root of time being the most straightforward choice), would be acceptable. APRA had previously stated that scaling should only be applied to interest rate changes, not to profit and loss figures. APRA has now decided that scaling of profit and loss figures would also be acceptable; it recognises that this is generally a simpler approach to implement in the asset-liability risk management systems in common use, than one involving scaling the interest rate changes. This changed view is reflected in APG 117.

Non-interest income

Comments received and issues raised

ADIs are expected to include in their risk analysis and capital calculations the sensitivity of all banking book items whose economic value is sensitive to changes in interest rates. This is not limited to items that generate interest income but also includes items that are sources of non-interest income.

APRA was asked to confirm that ADIs need to incorporate non-interest income only where material interest rate risk is found.

APRA's prudential approach

APRA's general approach to the materiality of items will apply to the inclusion of risk from non-interest income as well. The interest rate risk on an item may be disregarded if it only generates non-interest rate income and the risk to the item's economic value from interest rate changes is immaterial. However, an ADI will need to demonstrate a sound basis, at the time of approval and periodically thereafter, for deciding the immateriality of such items in the context of the total amount of IRRBB.

Qualitative requirements

Comments received and issues raised

The final draft of APS 117 proposed a system of qualitative requirements for the management of IRRBB.

Submissions raised the following concerns about APRA's proposed approach:

- the requirement that the Board be actively involved in the oversight of the management and measurement of IRRBB could also be met by a Board Committee; and
- the role of the independent IRRBB management function potentially incorporates some activities that are conducted by the treasury or markets function, particularly risk mitigation, thereby making independence hard to achieve.

APRA's prudential approach

APRA agrees it is reasonable for a Board Committee, rather than the Board itself, to be actively involved in the oversight of the management and measurement of an ADI's IRRBB. This change is now reflected in APS 117.

APS 117 now defines the role of the independent IRRBB management function to include the activities of monitoring and analysis, and designing and ensuring implementation of the risk management framework, but to exclude risk mitigation activities (which are capable of being interpreted to include market operations).

Chapter 4 – Market risk

Review of submissions

There were eight submissions on the draft of *Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116)*, and accompanying *Prudential Practice Guide APG 116 (APG 116)*, released in August 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This chapter examines the main issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Transitional provisions

Comments received and issues raised

The draft of APS 116 introduced requirements for ADIs beyond those in the existing prudential standard on market risk (the 'old APS 113'). The draft also required that an ADI wishing to use an internal model to calculate market risk regulatory capital to seek written approval from APRA, and that an ADI wishing to be exempt from APS 116 to seek written approval from APRA for such an exemption.

Submissions noted that it may take time after 1 January 2008 to implement changes necessary to comply with APS 116 and sought clarity on APRA's approach to ADIs that are not fully compliant as at 1 January 2008. Clarity was also sought on APRA's approach to exemptions for ADIs without trading books.

APRA's prudential approach

ADIs with internal model approval under the old APS 113 will not be required to re-apply for internal model approval under APS 116. The multiplication factor on 1 January 2008 for those ADIs will be based on their compliance with the old APS 113. Instead, ADIs with internal model approval under the old APS 113 will be required to submit to APRA a written self-assessment against APS 116 by 1 October 2008. To the extent that an ADI's self-assessment identifies gaps, APRA may require the ADI to submit a proposed timetable for the closure of these gaps. Should the ADI fail to ensure timely closure of the gaps, APRA may consider other regulatory responses (such as an increased multiplication factor).

APS 116 makes clear that ADIs that do not have trading activity or foreign exchange and commodity positions – and are thus currently exempt from the capital and reporting requirements of the old APS 113 – will not be required to apply for such an exemption under APS 116. However, should the ADI commence trading activity and/or hold foreign exchange or commodity positions, APS 116 will apply.

Trading book definition

Comments received and issues raised

The draft of APS 116 proposed that, for a position to be eligible to receive trading book capital treatment, an ADI must have a clearly documented trading strategy for the position/instrument or portfolios (which must include the expected holding period), approved by senior management.

Submissions suggested that the requirement to specify an expected holding period be removed or that APRA clarify what it regards as an acceptable holding period for trading book instruments.

APRA's prudential approach

APRA does not believe it is appropriate to deviate from the Framework on this issue. The specification of an expected holding period provides clarity in the assessment of whether positions are being held for the 'short-term' in the context of trading book eligibility, and helps ensure that non-trading positions are excluded from the trading book. APG 116 states that it is good practice for a trading book policy statement to set out a maximum holding period of no more than 180 days.

Reporting lines for the valuation function

Comments received and issues raised

The draft of APS 116 proposed that the reporting line for the valuation function must ultimately be to a responsible Board executive director and be independent of front office.

Submissions sought clarity on whether multiple reporting lines for the valuation function would be sufficient if one of the reporting lines is to an executive director, and recommended that matrix reporting be acknowledged as complying with the standard.

APRA's prudential approach

APS 116 confirms that the reporting line for the valuation function must be independent of front office and (unless otherwise approved by APRA) ultimately to a Board director. APRA recognises that the reporting structures of ADIs vary and it will consider whether a particular reporting structure provides appropriate independence and accountability for the valuation function.

Comparison of valuation requirements against AIFRS

Comments received and issues raised

The draft of APS 116 proposed that an ADI must use the more prudent side of the bid/offer spread unless it is a significant market-maker in a particular position type and can close-out at mid market. The draft also proposed that ADIs consider the need to establish valuation adjustments/reserves and to review their appropriateness on an ongoing basis.

Submissions noted that the requirement to incorporate the more prudent side of the bid/offer spread is more onerous than the Australian equivalents to International Financial Reporting Standards (AIFRS), which allow for *ex post* adjustments at least twice a year. Submissions asserted that this proposal is impractical to implement for liquid portfolios. Submissions also noted that reserving for liquidity considerations may be divergent from the notion of fair value under AIFRS and that the requirement for 'ongoing' review of valuation adjustments may imply undertaking reviews more frequently than necessary (perhaps daily). Further guidance was requested on the requirement to 'consider the need' to establish reserves.

APRA's prudential approach

APS 116 now clarifies that, in respect of bid/offer spreads, ADIs will be required to use an appropriate price in accordance with AIFRS. However, consistent with the Framework, the valuation adjustments and reserves made in accordance with the standard must impact on Tier 1 capital. This may exceed those generally made under AIFRS. An increase in valuation and reserves will result in a reduction in Tier 1 capital. Where an amount cannot be created as a position

or reserve, it may form part of retained earnings not available for distribution and must be clearly disclosed in accordance with AIFRS in financial reports.

APRA will expect an ADI to establish formal procedures to consider the need to establish reserves, which address the factors listed in the standard. APRA agrees that it is unnecessary to undertake daily reviews of valuation adjustments, and has amended APS 116 to require reviews to be undertaken on a regular (at least monthly) basis.

Application of APS 116 to ADIs with offshore sites

Comments received and issues raised

The draft of APS 116 proposed that an ADI that manages market-related activities centrally must seek written approval from APRA to calculate its traded market risk, foreign exchange and commodities (TFC) capital requirement on a globally consolidated basis. Submissions sought further details on these proposals.

APRA's prudential approach

APS 116 clarifies the types of calculations that may be permitted for ADIs with offshore sites. In addition, ADIs will not be required to seek approval for such calculations but will be permitted to calculate capital allowing for offsets and diversification effects between sites, unless APRA requires otherwise.

Use of a combination of the internal model and standard method

Comments received and issues raised

The draft of APS 116 proposed that an ADI must seek APRA's written approval to use a combination of the internal model approach and the standard method. However, an ADI must not use a combination of the two methodologies within a particular risk category (e.g. interest rates, foreign exchange, equities and commodities) and within the same regional centre, without prior written approval from APRA.

Submissions requested that APRA clarify whether ADIs are required to seek approval to use a combination of the two methodologies within a particular risk category on a product-by-product basis and clarify how it may apply to a transaction that covers two risk types, one covered under the standard method and the other by the internal model.

APRA's prudential approach

APRA's approach to internal model approvals is based on a 'model summary document' that includes, *inter alia*, a description of which products are subject to internal model calculations and which are subject to standard method calculations, based on broad product groupings.

An ADI may seek approval for a process whereby the TFC capital for new products may be calculated via the standard method (despite other products of the same risk type being calculated via the internal model), prior to their inclusion in the model. The expectation would be that the products would be migrated to the internal model in a timely fashion, particularly if transactional volumes or exposures become significant.

Where a transaction involves two types of risk, one which is normally captured in the internal model and the other by the standard method, an ADI may capture the two different types of risk under two different methods or, for pragmatic reasons may allow the transaction to be captured entirely by the standard method.

Chapter 5 – Securitisation

Review of submissions

There were 14 submissions on the final draft of *Prudential Standard APS 120 Securitisation (APS 120)*, released in July 2007. Comments covered a range of issues including technical, drafting and interpretation issues. This chapter examines the main new issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Transitional arrangements

Comments received and issues raised

The final draft of APS 120 proposed a two-year, case-by-case transitional arrangement under which ADIs would need to apply for capital relief by the end of 2007. There was no automatic exemption or any concession beyond two years.

Submissions argued that existing approved securitisation schemes should be automatically taken to comply with the new requirements and not be subject to any additional capital charge. This argument was based on the difficulty in restructuring facilities and programs that may still have some years to run in order to comply with the revised separation criteria, the threshold rate clause provisions and the criteria to avoid capital deduction for unrated facilities. Submissions stated that this process could be difficult, costly and time-consuming and could involve obtaining investor agreement and the need for rating agency analysis; it was also stated that, in some cases, ratings could be downgraded for existing programs if certain protections have to be removed (such as date-based calls), and investors may not agree to this.

Submissions also argued that, given the timeframe for finalising the prudential standard, many ADIs would not be in a position to obtain transitional approval prior to the end of 2007.

APRA's prudential approach

APRA had previously stated that it was not attracted to the broad grandfathering of all existing arrangements. APRA remains strongly of this view.

APRA believes that revisions to the restrictions on threshold rate clauses in APS 120 will address a major area of potential concern. In addition, an ADI will not be required to make changes to program documentation for some of the other new requirements in APS 120, if it commits to APRA to use its discretions under the contractual arrangements to comply with these requirements (e.g. it agrees not to exercise a date-based call prior to the 10 per cent threshold being met).

Further, to facilitate the transitional process, APRA will give ADIs an additional period to assess how existing approved securitisation schemes sit against the requirements of APS 120. The application of the new operational requirements of APS 120 will be delayed for six months but ADIs will be subject to the new Basel II capital calculations for standardised and IRB banks (as if the operational requirements are met) from 1 January 2008.

APRA will also provide automatic exemption from the new operational requirements of APS 120 for any programs or facilities that roll-over or terminate during 2008, until their termination or roll-over date. This will address issues with most current asset-backed commercial paper (ABCP) programs, which are generally 364-day facilities, and will alleviate the need to review programs that will not be outstanding for a long period.

IRB methodology for unrated facilities

Comments received and issues raised

Consistent with the Framework, the final draft of APS 120 only allows an ADI using the IRB approach to use the internal assessment approach (IAA) for facilities extended to an ABCP securitisation.

Submissions argued that the IRB methodologies available for unrated securitisation exposures (such as liquidity facilities) will be very difficult to apply, since these methodologies assume that the ADI always has detailed information on every exposure in the pool. In practice, an ADI that provides a liquidity or funding facility to a special purpose vehicle (SPV) may have portfolio level data but not the individual probability of default (PD) and loss-given-default (LGD) for each loan.

APRA's prudential approach

The IRB approach allows an ADI to use the IAA approach, which involves recreating a rating-agency type analysis based on portfolio characteristics, to facilities provided to ABCP programs. Extending this methodology to other types of securitisations would mitigate some of the concerns the industry has with certain facilities, such as funding facilities for warehouses.

Given the recent market experience with ABCP programs, APRA sees no strong justification for allowing a concessional treatment to ABCP programs relative to standard securitisation exposures. APRA therefore proposes to depart from the Framework and allow the IAA methodology to be applied as well to non-ABCP programs, subject to APRA's approval.

Required rate and threshold rate arrangements

Comments received and issues raised

In the final draft of APS 120, APRA proposed some restrictions on the use of required rate clauses, which are agreements with the originating ADI that set a minimum interest rate on securitised loans to ensure the receipts can cover payments on the securities. APRA's concern was that an ADI could be required to adjust its own lending rates if an SPV's costs increased or its credit standing was downgraded.

Submissions argued that these restrictions conflict with the principle that an SPV should be financially independent and therefore be able to price and manage its own assets. Submissions also noted that it would be difficult to restructure many existing securitisations to meet these requirements as it was unlikely that the requisite approvals would be provided by investors and rating agencies.

APRA's prudential approach

APRA acknowledges these arguments. In principle, a required rate clause allowing an SPV to cover its funding or other costs using its own assets would not raise prudential concerns if any changes to borrowing rates affect only the securitised exposures and not those still held by the originating ADI. Concerns arise if required rate clauses extend to the rate the originating ADI can be required to charge on its other non-securitised loans or if the ADI can choose to absorb an increase in the SPV's funding costs itself rather than passing it on to its customers. Such arrangements can give rise to implicit support, particularly where they can compromise the ADI's ability to competitively price new business.

In balancing these viewpoints, APRA has removed the specific restrictions on the use of required rate clauses from APS 120 itself but has clarified in *Prudential Practice Guide APG 120* (APG 120) that it would not expect an originating ADI to:

- absorb any of the interest cost of its customers in lieu of not charging the full required or threshold rate; and
- actively seek to refinance, or make a general offer to refinance, loans it originated into an SPV where the required/threshold rate is out of the market.

These expectations will be included among a number of examples of situations that could be seen as providing implicit support.

International consistency considerations

Comments received and issues raised

APRA had earlier set out several areas on which it was not prepared to depart from the Framework without very strong reasons. APRA also noted, however, that it would consider these issues going forward if they were found to have a significant impact on the functioning of the securitisation market in Australia.

A number of submissions reiterated previous comments on the implications of changes due to the implementation of the Framework and APRA-initiated changes. This category of issues includes:

- requirements for ratings to be public in order to be used for capital purposes;
- narrowing of the definition of 'originating ADI' to limit the application of many of the APS 120 requirements;
- the prohibition on date-based calls, unless 10 per cent or less of the program remains outstanding;
- the general prohibition on repurchases of assets from programs;
- credit conversion factors for liquidity facilities used for general market disruptions; and
- requirements for legal opinions as to enforceability and APRA discretion to request legal opinions.

APRA's prudential approach

In many cases, APRA has confirmed its previous decision and has not made any change to its approach. A number of technical suggestions have, however, been addressed in APS 120. In addition, a number of requests for clarification and further detail have been accommodated in APG 120.

In the absence of evidence that prudential regulators overseas are prepared to depart from the Framework on core requirements, APRA is not at this stage proposing to reconsider its approach, particularly in light of recent market developments.

Chapter 6 – Public disclosure of prudential information

Review of submissions

There were 10 submissions on the draft of *Prudential Standard APS 330 Capital Adequacy: Market Disclosure* released in June 2007 and now renamed *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information (APS 330)*. Comments covered a range of issues including technical, drafting and interpretation issues. This section examines the main issues raised and APRA's response in each case. It also addresses issues raised through other channels.

Quarterly reporting

Comments received and issues raised

A number of submissions raised concerns about quarterly prudential disclosures, arguing that:

- quarterly public reporting as a general principle is unnecessary since the Australian Securities Exchange (ASX) requires listed companies to disclose events that materially affect share prices in the period between published financial reports;
- while the draft of APS 330 does not explicitly require quarterly profit disclosure, the proposed disclosure of the granular components of the capital structure is sufficient for market analysts to accurately estimate quarterly profit. The market would, therefore, pressure ADIs to provide explanations of movements in the items disclosed to explain profit changes, leading ultimately to full quarterly disclosure;
- there is no market appetite for quarterly reporting; and
- increased compliance and other costs would outweigh any benefit in terms of increased market discipline.

Submissions also argued that semi-annual/annual reporting for listed ADIs aligns with ASX listing rules and that APRA would still have access to detailed quarterly capital adequacy information through the prudential reporting regime.

APRA's prudential approach

APRA views industry's main concern in this area as relating to the disclosure of information on quarterly profitability or, more particularly, 'off-quarter' profitability (i.e. where the quarter does not correspond to an ASX/ASIC statutory reporting period). APRA sees merit in these arguments, and also notes related concerns about the quality of off-quarter information, which is not generally subject to the same rigorous review procedures as financial information that is required to be disclosed publicly. At the same time, APRA continues to see benefit in the regular public disclosure of some basic capital adequacy information on all ADIs, consistent with the principles of market discipline underlying Pillar 3 of the Framework.

APRA has decided, therefore, to remove the requirement to make public disclosures of retained earnings and other dollar amounts where the reporting period does not coincide with a semi-annual and/or annual financial reporting date, but to retain the requirement where these do coincide. The requirement to disclose some basic information on capital ratios and credit risk exposure on a quarterly basis stands.

Disclosures by foreign-owned ADIs

Comments received and issues raised

A concern was expressed that Australian banks would face an uneven playing field in accessing global capital markets if they were required to disclose greater detail than their foreign counterparts. It was noted that this risk would be lessened if home regulators of the foreign-owned banks in Australia require a similar level of disclosure to APRA.

APRA's prudential approach

Under APS 330, APRA can require a foreign-owned ADI that has APRA's approval to use the advanced Basel II approaches to increase the content and/or frequency of its prudential disclosures beyond the basic levels required under Part B. APS 330 notes that one of the factors APRA will consider in coming to a decision in this regard is the quality of disclosure by the overseas parent in its home jurisdiction.

More generally, under APS 330 APRA can vary the minimum disclosure requirements for any individual ADI, including any foreign-owned institutions.

Order/layout of disclosures

Comments received and issues raised

This matter was not canvassed in submissions but APRA's separate discussions with industry representatives identified that there may be areas where some specific items of information to be disclosed might, for presentational purposes, be better shown in a different order from that required under APS 330.

APRA's prudential approach

APRA sees benefit, in terms of allowing readers to make ready comparisons across institutions and time, in adhering to the order/layout of the prudential disclosures as set out in Attachments A and B, which reflect the requirements of the Framework. That said, APRA will assess the effectiveness of the order/layout of information as part of its monitoring of ADIs' initial prudential disclosures.

Medium/location of disclosures

Comments received and issues raised

One concern raised was that ADIs might make their prudential disclosures difficult to locate on their websites, despite fulfilling the requirement that they be published in full in one location. A suggestion was made that APS 330 make it clearer that readers must be able to readily access the prudential disclosures.

APRA's prudential approach

APRA has revised APS 330 to require prudential disclosures to be published in full in a clearly identifiable location on an ADI's website.

Proprietary and confidential information

Comments received and issues raised

Submissions argued that the proposed requirement in the draft of APS 330 to provide explanations in every instance of 'non-disclosure' might tend to draw attention to the information excluded and lead to speculation as to its nature; at the same time, any detailed explanation of the exclusion may effectively force disclosure of what was considered proprietary or confidential. The suggestion was made that a blanket statement be included noting that certain proprietary or confidential information has been excluded.

APRA's prudential approach

APRA's concern is that ADIs do not avoid the disclosure of information that is important in the context of market discipline. The Framework sees its Pillar 3 disclosure proposals as striking an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information, so that a provision for non-disclosure is only intended to be applied in exceptional circumstances. Against this background, APRA has not made any changes to APS 330 in this regard.

Timing of disclosures

Comments received and issues raised

Submissions sought clarification of certain timing aspects, including APRA's intentions regarding commencement of the required disclosures. It was suggested that the first disclosures for ADIs using the advanced approaches should include both the qualitative and quantitative disclosures required under Attachment A. Some submissions also pointed to the proposed 40-business day publication deadline as being inconsistent with ASX reporting timelines for listed institutions (60 calendar days for semi-annual accounts and 75 calendar days for annual accounts) and argued that the timelines be brought into alignment.

APRA's prudential approach

APRA has decided that, unless advised otherwise, ADIs will commence publication of their prudential disclosures with the required disclosures for the period ending 30 September 2008. ADIs using the advanced approaches will be required to make a full set of Attachment A disclosures at that time and all ADIs will be required to disclose their quarterly set of basic information.

APRA has also decided not to change its publication deadline. This deadline is already double the length of the deadline applying to the quarterly submission to APRA of ADI prudential reports, including those relating to capital adequacy. The deadline equates to a calendar-day equivalent of 56 days, well beyond the typical publication lag for financial reports released by ADIs, particularly those that are listed. However, where an unlisted ADI is required to disclose details on its capital structure, APRA will allow it to delay publication of this information until after its annual financial reports are lodged with ASIC.

Verification of disclosures

Comments received and issues raised

Submissions sought clarification of the wording of the verification requirements and requested that APRA provide a 'sample wording' for the required CEO attestation of the accuracy and correctness of the disclosures. Comment was also made about the need for a 'second round of audit' for the prudential disclosures.

APRA's prudential approach

APRA has refined the wording of APS 330 on verification requirements and will consider developing a sample CEO attestation as part of its ongoing review of audit and related arrangements for prudential reporting.

APRA emphasises that, consistent with the Framework, there is no requirement for the prudential disclosures to be separately audited by an external auditor.

Finally, APRA notes that the Australian Bankers' Association has convened a working group to derive specific definitions of the risk measures that will be required to be disclosed under APS 330. The working group is looking to liaise with similar groups that have been established overseas in the interest of achieving international consistency. APRA supports this industry initiative and is already working closely with the working group, which is also looking to develop sample reports for the quantitative disclosures required under APS 330.



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