



Response to Submissions II

Implementing Basel III capital reforms in Australia

28 September 2012

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Preamble

In September 2011, the Australian Prudential Regulation Authority (APRA) released a discussion paper, *Implementing Basel III capital reforms in Australia*, outlining its proposals to implement a package of reforms to strengthen the capital framework for authorised deposit-taking institutions (ADIs) in Australia. These reforms give effect to the measures announced by the Basel Committee on Banking Supervision (Basel Committee) in December 2010 to strengthen global capital rules so as to promote a more resilient global banking system. These measures are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* and are known as 'Basel III'.

In March 2012, APRA issued a paper responding to submissions received on its September 2011 proposals and released for consultation five draft prudential standards:

- *Prudential Standard APS 001 Definitions (APS 001)*;
- *Prudential Standard APS 110 Capital Adequacy (APS 110)*;
- *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*;
- *Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements (APS 160)*; and
- *Prudential Standard APS 222 Associations with Related Entities (APS 222)*.

A further discussion paper outlining APRA's proposed amendments to reporting requirements was released for consultation in June 2012, accompanied by two draft reporting standards:

- *Reporting Standard ARS 110.0 Capital Adequacy (ARS 110.0)*; and
- *Reporting Standard ARS 111.0 Fair Values (ARS 111.0)*.

Also in June 2012, APRA wrote to industry inviting submissions on its proposals that Additional Tier 1 and Tier 2 Capital instruments be subject to Australian law and that, for regulatory capital purposes, joint operations be accounted for in the same manner as joint ventures.

This paper responds to the consultations described above. Accompanying the paper are final versions of the prudential and reporting standards released for comment in March and June, respectively. These standards come into effect on 1 January 2013.

APRA has been consulting separately on its proposals to implement the Basel III measures on counterparty credit risk and on other changes, as outlined in its August 2012 discussion paper *Implementing Basel III capital reforms in Australia: counterparty credit risk and other measures*. APRA will be releasing its response to submissions received on these proposals and finalising prudential standards and prudential practice guides implementing these measures in November 2012.

Finally, APRA is inviting submissions on its proposal to implement Basel III requirements in relation to disclosures by external credit assessment institutions and the minimisation of cliff effects from guarantees and credit derivatives. These proposed changes will be incorporated in the prudential standards that are to be finalised in November 2012. Submissions should be forwarded by 26 October 2012 by email to Basel3capital@apra.gov.au and addressed to:

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This response paper and the final prudential and reporting standards are available on APRA's website at www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx.

Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine any such requests in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

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Glossary

AASB 11	<i>AASB 11 Joint Arrangements</i>
AASB 13	<i>AASB 13 Fair Value Measurement</i>
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 001	<i>Prudential Standard APS 001 Definitions</i>
APS 110	<i>Prudential Standard APS 110 Capital Adequacy</i>
APS 111	<i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i>
APS 112	<i>Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk</i>
APS 113	<i>Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk</i>
APS 160	<i>Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements (now Attachment K to APS 111)</i>
APS 222	<i>Prudential Standard APS 222 Associations with Related Entities</i>
APS 310	<i>Prudential Standard APS 310 Audit and Related Matters</i>
ARS 110.0	<i>Reporting Standard ARS 110.0 Capital Adequacy</i>
ARS 111.0	<i>Reporting Standard ARS 111.0 Fair Values</i>
August 2012 discussion paper	<i>Discussion Paper, Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures, August 2012</i>
Banking Act	<i>Banking Act 1959</i>
Basel Committee	Basel Committee on Banking Supervision
Basel III	<i>Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee, December 2010 (revised June 2011)</i>
BOP	Bonus option plan
CPG 110	<i>Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and supervisory review</i>
DRP	Dividend reinvestment plan
ECAI	External credit assessment institution
ECAI Guidelines	<i>Guidelines on Recognition of an External Credit Assessment Institution, APRA, January 2008</i>

ICAAP	Internal Capital Adequacy Assessment Process
June 2012 discussion paper	Discussion Paper, <i>Implementing Basel III capital reforms in Australia: reporting requirements</i> , June 2012
March 2012 response paper	Response to Submissions, <i>Implementing Basel III capital reforms in Australia</i> , March 2012
PPF provider	Provider of purchased payment facilities
PPG	Prudential Practice Guide
RBA	Reserve Bank of Australia
September 2011 discussion paper	Discussion Paper, <i>Implementing Basel III capital reforms in Australia</i> , September 2011

Executive summary

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) released a package of reforms to raise the level and quality of regulatory capital in the global banking system (Basel III). APRA is a member of the Basel Committee and fully supports the implementation of these reforms.

In September 2011, APRA released a discussion paper outlining its proposals to implement these Basel III capital reforms in Australia. APRA subsequently released, in March and June 2012, draft prudential and reporting standards on which submissions were invited. In June 2012, APRA also invited submissions on its proposal that certain capital instruments be subject to Australian law and on its proposed regulatory capital treatment of joint arrangements. Fifteen submissions were received on the March and June 2012 consultation packages.

APRA's capital adequacy prudential and reporting standards

Submissions were broadly supportive of the content of the draft prudential and reporting standards and mostly sought clarification of particular provisions. In response, APRA has:

- clarified its expectations for an ADI's Internal Capital Adequacy Assessment Process (ICAAP), which are included in the draft *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and supervisory review (CPG 110)* recently released for public consultation;
- revised its proposed treatment of an ADI's funding of purchases of its own capital instruments, including margin loans;
- removed the 'profits test' from Additional Tier 1 and Tier 2 Capital instruments;
- clarified the operation of the countercyclical capital buffer;
- simplified transitional arrangements for capital issued by consolidated subsidiaries and held by third parties; and
- made minor changes to the prudential and reporting standards to improve ease of use.

Submissions raised concerns about APRA's proposal that certain capital instruments should be subject to Australian law. APRA acknowledges these concerns. In response, it has clarified areas of uncertainty about the loss absorption and non-viability requirements and has refined its approach to the question of governing law for capital instruments, such that only those provisions of capital instrument documentation dealing with loss absorption and non-viability must be governed by Australian law.

In June 2012, the Basel Committee finalised its proposals to improve consistency and ease of use of disclosures on capital positions and capital composition. These measures, which are to come into effect for reporting periods ending on or after 30 June 2013, include a common template and disclosure provisions that, if implemented, would facilitate comparison between the capital position of banking institutions across jurisdictions. APRA will consult in early 2013 on these requirements.

Consultation with industry and other interested stakeholders

The Basel III reforms also implement measures relating to external credit assessment institutions (ECAIs) and to minimise cliff effects arising from guarantees and derivatives. APRA invites written submissions on its proposals to implement these specific measures, which are set out in Chapter 8.

Chapter1 – Introduction

1.1 Overview

In its December 2010 document *Basel III – A global regulatory framework for more resilient banks and banking systems*¹, the Basel Committee released a package of reforms to raise the level and quality of regulatory capital in the global banking system. This comprehensive reform package included measures:

- to raise the quality, consistency and transparency of the capital base and to harmonise other elements of capital; and
- to improve the risk coverage of the Basel II Framework by strengthening the capital requirements for counterparty credit risk exposures arising from banks' derivatives, repurchase and securities financing activities.

In June 2011, the Basel Committee announced that it had finalised the Basel III capital treatment for counterparty credit risk in bilateral trades. In July 2012, the Basel Committee released interim rules for the Basel III capital treatment for exposures to central counterparties.

APRA commenced its formal consultation on the first set of Basel III measures – relating to the quality, consistency and transparency of the capital base – with the September 2011 release of its discussion paper *Implementing Basel III capital reforms in Australia* (the September 2011 discussion paper)². Consultation has continued in 2012. In March, APRA released a paper responding to submissions received on its September 2011 proposals (the March 2012 response paper)³. This paper was accompanied by five draft prudential standards. In June, APRA released a discussion paper (the June 2012 discussion paper)⁴ and draft reporting standards on its proposed changes to the reporting framework. Also in June, APRA wrote to industry inviting comments on two specific proposals: that

Additional Tier 1 and Tier 2 Capital instruments be subject to Australian law and that joint ventures and joint operations be treated in the same manner for capital adequacy purposes⁵.

This paper sets out APRA's response to specific issues raised in the nine submissions received on the draft prudential standards released in March, the four submissions received on APRA's 8 June 2012 letter and the two submissions received on the draft reporting standards. The paper does not revisit matters raised in earlier submissions.

In response to submissions, APRA has amended the draft prudential and reporting standards where there are sound prudential reasons to do so. This paper outlines those matters and clarifies areas of uncertainty.

APRA released a consultation package on its proposals to implement the second set of Basel III measures – relating to counterparty credit risk – in August 2012 (the August 2012 discussion paper)⁶. This response paper does not address submissions on this consultation package. APRA intends to respond to submissions and finalise the relevant prudential and reporting standards dealing with counterparty credit risk (and other minor Basel III measures) in November 2012.

APRA is consulting separately with mutually owned ADIs (mutual ADIs) on alternative measures to address aspects of the Basel III reforms that are problematic for institutions with this corporate structure, in particular, aspects of the loss absorption and non-viability conversion requirements. APRA is confident that an alternative arrangement that provides mutual ADIs access to non-common equity regulatory capital can be developed and it is in discussion with industry representatives on this topic. This response paper does not, however, address this topic.

1 *Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011*: www.bis.org/publ/bcbs189.htm

2 <http://www.apra.gov.au/adi/Documents/Basel-III-discussion-paper-September-2011.pdf>

3 *Response to Submissions, Implementing Basel III Capital reforms in Australia*, March 2012: [http://www.apra.gov.au/adi/PrudentialFramework/Documents/Basel III capital response to submissions 30 March 2012.pdf](http://www.apra.gov.au/adi/PrudentialFramework/Documents/Basel%20III%20capital%20response%20to%20submissions%2030%20March%202012.pdf)

4 *Discussion Paper, Implementing Basel III reforms in Australia - Reporting requirements*, June 2012: [http://www.apra.gov.au/adi/PrudentialFramework/Documents/120608 Discussion Paper Reporting Requirements.pdf](http://www.apra.gov.au/adi/PrudentialFramework/Documents/120608_Discussion_Paper_Reporting_Requirements.pdf)

5 *Basel III Capital – Governing Law and Joint Arrangements*, August 2012: [http://www.apra.gov.au/adi/PrudentialFramework/Documents/120608 Australian Law and Joint Arrangements.pdf](http://www.apra.gov.au/adi/PrudentialFramework/Documents/120608_Australian_Law_and_Joint_Arrangements.pdf)

6 *Implementing Basel III capital reforms in Australia - counterparty credit risk and other measures*, August 2012: [http://www.apra.gov.au/adi/PrudentialFramework/Documents/APRA Discussionpaper BASEL3 CCR FINAL 2.pdf](http://www.apra.gov.au/adi/PrudentialFramework/Documents/APRA_Discussionpaper_BASEL3_CCR_FINAL_2.pdf)

Finally, APRA acknowledges industry's continuing concerns about the comparability of capital positions of banking institutions across other jurisdictions. APRA will consult in 2013 on the Basel Committee's June 2012 *Composition of capital disclosure requirements – Rules text*⁷, which are intended to come into effect for financial statements on or after 30 June 2013. Included in these requirements is a common template that will enable investors and analysts to make cross-border comparisons for banking institutions in a straightforward and efficient way.

1.2 Final prudential and reporting standards

Concurrently with this response paper, APRA is releasing the final prudential and reporting standards that will implement the core Basel III capital measures from 1 January 2013.

These standards are:

- *Prudential Standard APS 001 Definitions (APS 001)*;
- *Prudential Standard APS 110 Capital Adequacy (APS 110)*;
- *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*;
- *Prudential Standard APS 222 Associations with Related Entities (APS 222)*;
- *Reporting Standard ARS 110.0 Capital Adequacy (ARS 110.0)*; and
- *Reporting Standard ARS 111.0 Fair Values (ARS 111.0)*.

The provisions in draft *Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements (APS 160)* issued in March 2012 have been incorporated into Attachment K to APS 111. APRA has also restructured APS 111 to improve ease of use.

1.3 Remaining Basel III measures

The second set of Basel III measures described in section 1.1 above includes measures to address reliance on external credit ratings and to minimise cliff effects. Many of these measures are already included in APRA's prudential standards and guidelines. However, some changes are required to implement specific transparency and disclosure requirements where ECAs are used by ADIs and to minimise cliff effects from guarantees and credit derivatives. Chapter 8 outlines APRA's proposals.

1.4 Other prudential standards

The final prudential standards released with this response paper implement the core Basel III reforms to the definition and measurement of regulatory capital. Other prudential standards and prudential practice guides implementing other aspects of the Basel III framework will be finalised in November 2012. They will incorporate the proposals outlined in:

- the August 2012 discussion paper on counterparty credit risk (and other Basel III measures); and
- Chapter 8 of this paper on the disclosure requirements for ECAs and measures to minimise cliff effects from guarantees and derivatives.

APRA will also make minor changes to other prudential standards before the end of 2012 to adopt Basel III terminology and update cross-references. There will be no substantive amendments to these standards, which will also apply from 1 January 2013.

⁷ www.bis.org/publ/bcbs221.htm

1.5 Other reporting standards

In November 2012, APRA will also finalise the reporting standards released for public consultation with the August 2012 discussion paper, relating to counterparty credit risk, revised risk-weight requirements and other measures.

APRA does not propose to finalise other reporting standards to update terminology and cross-referencing until 2013. APRA is currently consulting the life insurance, general insurance and superannuation industries on a proposal to change the basis of the reporting timeframes from business days to calendar days. Reporting on a business day basis requires both APRA and regulated entities to assess the impact of state-based public holidays on the actual due date for submission for a particular period, meaning that the actual due date can vary across reporting periods and across states. A calendar day reporting basis simplifies reporting deadlines and will result in deadlines for all institutions and all industries being aligned to the same due date.

APRA intends to consult ADIs on changing ADI reporting standards to a calendar day basis during 2013. That consultation will also cover other operational matters (e.g. submission methods, alignment with other APRA-regulated industries and reporting populations). It will include a review of submission timeframes (e.g. advanced ADIs reporting on a 20 business day (28 calendar days basis), as originally outlined in *Implementation of the Basel II Capital Framework 6. Basel II Reporting Requirements: Response to Submissions*⁸.

⁸ February 2008: www.apra.gov.au/adi/Documents/cfdocs/Basel-II-Reporting-Requirements-Response-Paper-Feb-08.pdf

Chapter 2 – Minimum capital requirements

2.1 Definition of capital

In the draft prudential standards released with the March 2012 response paper, APRA detailed the revised definition of regulatory capital, under which common equity is the predominant form of Tier 1 Capital. The draft standards also included APRA's proposed requirements for adopting the Basel III minimum requirements for Common Equity Tier 1, Tier 1 and Total Capital, and the stricter eligibility criteria for Tier 1 and Tier 2 Capital instruments, including mandatory conversion or write-down in times of stress. Expanded requirements governing an ADI's Internal Capital Adequacy Assessment Process (ICAAP) were also proposed.

2.1.1 Common Equity Tier 1 Capital: dividend reinvestment plans and bonus option plans

Comments received

A number of submissions raised concern that APRA's draft prudential standards did not allow dividend reinvestment plans (DRPs) or bonus option plans (BOPs) to be offset against declared current year dividends. The concern was that APRA's approach would distort an ADI's capital position for the period between dividend declaration date and the date shares are issued under DRPs/BOPs. Submissions suggested that this capital volatility could be addressed by allowing expected DRP take-up to be reflected in an ADI's regulatory capital on the DRP announcement date, followed by an adjustment once the final DRP participation rate is known on the record date. This would allow recognition of dividends and DRPs within the same reporting quarter.

APRA's response

APRA has revised its position to allow new shares purchased under DRPs to offset declared dividends. The estimated take-up rate for DRPs must be agreed in advance with APRA and reviewed semi-annually. Where there is a material departure from the estimated level of subscription, an ADI is required to notify and agree with APRA a revised future DRP take-up rate for regulatory capital purposes.

APRA's longstanding policy to allow DRPs to be recognised is based on the assumption that DRPs result in an increase in capital. This can only occur where dividend payments that would otherwise be made are used to fund new shares, not to purchase existing ones. APRA has therefore amended APS 111 to clarify that DRPs may only be recognised where new shares are issued and additional capital is generated.

In APRA's view, BOPs are not relevant for offsetting dividends as no new capital is generated.

2.1.2 Additional Tier 1 and Tier 2 Capital: incentives to redeem

To be included in regulatory capital, the Basel III rules text prohibits Additional Tier 1 and Tier 2 Capital instruments from including provisions that operate as incentives to redeem the instruments. These prohibitions prompted a number of submissions as to whether particular features would constitute such an incentive.

Comments received

Submissions queried:

- APRA's proposal to disallow a call date less than two years prior to a mandatory conversion, on the basis that the Basel Committee only prohibits call options that are 'combined with' a conversion right. One submission suggested that this period should be reduced to six months while another proposed aligning it with coupon payment dates. A further suggestion was that APRA retain the two-year moratorium but consider each call request on a case-by-case basis;
- whether an instrument can include contractual provisions under which, in a change of control event, an ADI that does not exercise a right to redeem must instead convert the instrument into ordinary shares; and
- the factors that APRA will consider in determining whether a replacement instrument with a higher credit spread is an incentive to redeem.

APRA's response

APRA remains of the view that there should be a clearly defined period between a call date and a conversion date in order for the call option not to be, in substance, an incentive to redeem. APRA does not accept that a period shorter than two years is appropriate.

In APRA's view, a right to convert where an ADI has an option to redeem (whether on a change of control event or otherwise) constitutes an incentive to redeem and is therefore prohibited.

In general, APRA does not consider it prudent to attempt to pre-define instrument characteristics that provide an 'incentive to redeem'. As outlined in previous discussion papers, APRA will make this determination on a case-by-case basis.

2.1.3 Additional Tier 1 and Tier 2 Capital: calls or conversion within five years

Comments received

The Basel III rules text allows Additional Tier 1 and Tier 2 Capital to be called within five years of issue only for tax or regulatory events (subject to supervisory approval). A number of respondents sought APRA's confirmation that a change in accounting standards constitutes a regulatory event. Clarification was sought, firstly, as to whether conversion into Common Equity Tier 1 Capital within the first five years as a result of a change of control event is permitted and, secondly, as to whether an ADI could call an instrument on a change of control event within five years where this could be achieved without affecting the ADI's capital position.

APRA's response

A primary objective of the Basel III reforms is to improve the quality of regulatory capital. Allowing capital instruments to be called within five years clearly defeats this objective. The Basel III rules text only allows such calls in exceptional circumstances. APRA does not accept that a change in an accounting standard *per se* is a regulatory event warranting early redemption as it would not necessarily result in a change to regulatory capital. However, a change in an accounting standard that affects the eligibility of the instrument as regulatory capital may be considered by APRA to be a regulatory event. ADIs should consult with APRA on a case-by-case basis where they believe that a change in accounting standards constitutes exceptional circumstances.

APRA does not object to conversion to ordinary shares within five years of an instrument's issue date. However, if an option to convert associated with a change in control sees the capital transferred to another entity, the replacement capital injection must occur simultaneously with the substitution of issuer and must be unconditional. Where a capital instrument is converted into a like capital instrument, the new capital instrument must in its own right meet all the eligibility criteria for that category of capital instrument.

APRA does not, however, propose allowing calls to be made within the first five years of an instrument for a change of control event.

2.1.4 Additional Tier 1 and Tier 2 Capital: resale mechanisms

Comments received

A query was received as to whether a resale mechanism, under which an issuer nominates a third party to buy an instrument from investors, and from which the issuer may subsequently re-purchase that instrument under an issuer call option or buyback, operates as an incentive to redeem the instrument.

APRA's response

APRA's view is that a mechanism that requires a holder to sell the instrument to a nominated party other than the issuer or a related party of the issuer will not constitute an incentive to redeem, provided there is at least a two-year gap between the date upon which the holder is required to sell the instrument to the third party and the date upon which conversion may take place.

2.1.5 Additional Tier 1 and Tier 2 Capital: accounting matters

Submissions queried APRA's proposed valuation approach and the hedging of Additional Tier 1 and Tier 2 Capital instruments. In particular, submissions sought advice on:

- the valuation approach (i.e. fair value or amortised cost) to be used for Additional Tier 1 and Tier 2 Capital instruments for regulatory capital purposes. Submissions asked whether these instruments are to be recorded in capital at amortised cost (face value) or at fair value. In addition, clarification was sought on how to treat these instruments for movements in fair value due to changes in an ADI's own creditworthiness; and
- how hedges of capital instruments are recognised for regulatory capital purposes and whether this treatment applies to each Additional Tier 1 or Tier 2 Capital instrument or on a portfolio basis.

APRA's response

Valuation approach and changes in own creditworthiness for Additional Tier 1 and Tier 2 Capital instruments

APRA does not intend to mandate how capital instruments should be measured (i.e. at fair value or at amortised cost) for regulatory capital purposes. In general, an ADI would use the same valuation approach that it has adopted for financial reporting under applicable accounting standards. Under the accounting standards, an ADI can choose to measure some capital instruments that are classified as liabilities at either fair value or at amortised cost.

The exception is when the fair value changes in capital instruments have arisen from changes in an ADI's own creditworthiness. APS 111 will implement Basel III requirements that eliminate from Common Equity Tier 1 Capital all unrealised fair-valued gains and losses of liabilities that have resulted from changes in an ADI's own creditworthiness. The fair value effects of own creditworthiness must also be eliminated from the valuation of Additional Tier 1 and Tier 2 Capital instruments as a regulatory adjustment in the calculation and reporting of regulatory capital.

Hedging of capital instruments

The treatment of hedging for regulatory capital purposes, including whether hedging could be applied on an individual instrument or portfolio basis, will generally follow applicable accounting standards.

However, where a hedge is in respect of own creditworthiness, the treatment will depart from the accounting standards. APS 111 does not allow the required Common Equity Tier 1 Capital regulatory adjustment of the unrealised gains and losses due to own creditworthiness to be offset by any unrealised gains and losses from hedges against changes in an ADI's own creditworthiness. The accounting effects of hedges for own creditworthiness on capital instruments will flow through to Common Equity Tier 1 Capital for regulatory capital calculation and reporting purposes. The wording in APS 111 has been amended to reflect this outcome.

2.1.6 Treatment of joint arrangements⁹

In its June 2012 letter to industry and the June 2012 discussion paper, APRA proposed that for Basel III capital adequacy purposes, 'joint ventures and joint operations...be treated in exactly the same manner...[and]...that ADIs adopt the same accounting treatment (i.e. equity accounting) for both joint operations and joint ventures'.

⁹ Joint arrangements are defined in accordance with AASB 11 *Joint Arrangements* (AASB 11) and comprise of both 'joint ventures' and 'joint operations'.

Comments received

One submission proposed that APRA recognise the accounting approach for joint operations for capital purposes as it would limit the extent to which two sets of books are maintained (i.e. one for accounting and one for regulatory capital).

APRA's response

APRA has retained its proposed requirement that all joint arrangements be treated in the same manner for capital purposes. This removes incentives for regulatory capital benefits driven by structuring rather than reduction of risk. There will always be an element of dual reporting whether or not the accounting requirements for joint arrangements are followed¹⁰.

2.2 Loss absorption and non-viability

In its discussion papers and draft prudential standards, APRA set out its requirements for capital instruments, other than ordinary shares, to convert to ordinary shares or be written-off in certain circumstances. Under these requirements¹¹:

- an Additional Tier 1 Capital instrument classified as a liability for accounting purposes must provide that the instrument will convert or be written off where the Common Equity Tier 1 Capital of the ADI falls to, or below, 5.125 per cent of risk-weighted assets (the loss absorption requirement); and
- an Additional Tier 1 or Tier 2 Capital instrument must include a provision under which, on the occurrence of a non-viability trigger event, it will convert or be written off (the non-viability requirement)¹².

A number of submissions queried aspects of the loss absorption/non-viability requirements, which are addressed below.

¹⁰ Following the accounting approach for joint operations in AASB 11 would still require a manual adjustment to risk-weighted assets.

¹¹ *Minimum requirements to ensure loss absorbency at the point of non-viability*, 13 January 2011: www.bis.org/press/p110113.htm

¹² The trigger is a decision by APRA (or the host regulator) that, without conversion/write-off, the ADI would become non-viable or would require a public sector injection of capital.

2.2.1 Existing Banking Act powers

Comments received

One submission noted that section 14AA of the *Banking Act 1959* (the Banking Act) currently allows an APRA-appointed statutory manager of an ADI to cancel, sell or vary the terms of any preference share issued by the ADI. This submission queried APRA's rationale for introducing a similar requirement in APS 111; it was argued that these requirements create a perception of increased risk, which could affect investor appetite and increase pricing.

APRA's response

APRA does not agree with the view that section 14AA replicates the Basel III loss absorption/non-viability requirements. A pre-condition for cancelling or varying shares under this provision is the appointment of a statutory manager, which itself requires certain pre-conditions to be met. Different triggers apply to the activation of loss absorption/non-viability provisions, although there may be instances where there is overlap. In other instances, the operation of loss absorption/non-viability provisions would occur before appointing a statutory manager or may operate to avoid the need to consider doing so.

APRA also notes that, under the Australian Constitution, just compensation is likely to be required where shares were, for instance, written off in accordance with section 14AA. Under Basel III, compensation (if any) would be paid in accordance with an instrument's contractual terms and where there is no conflict with the primary objective of the loss absorption/non-viability rules to improve an ADI's capital position.

In any event, section 14AA powers relate only to shares and not to other instruments that must provide for conversion and/or write-off under Basel III. APRA is therefore retaining its proposed APS 111 requirements.

2.2.2 Governing law

Comments received

In its June 2012 letter, APRA proposed that, to be eligible for inclusion in regulatory capital, Additional Tier 1 and Tier 2 Capital instruments would be required to be subject to Australian law. This proposal was to facilitate the effective operation of the loss absorption and non-viability requirements in a crisis. Submissions raised a number of concerns about APRA's proposal, arguing:

- it would be difficult to apply Australian law to all contractual terms relating to an instrument, given the range of different documents and ancillary agreements;
- that instruments issued across jurisdictions are regularly governed by English or New York law with resolution mechanisms (such as liquidation) subject to the governing laws of the issuing institution's domestic jurisdiction;
- Australian law is not well understood and accepted in overseas capital markets;
- that APRA's approach may be adopted by other supervisors, causing jurisdictional conflict and potential impediments to timely conversion/write-off;
- APRA's concerns may be met by requiring an ADI to submit an independent legal opinion confirming that conversion/write-off will be achieved under the law governing the instrument; and
- the proposal potentially reduces the ability of offshore subsidiaries of ADIs to access capital markets independently.

APRA's response

APRA acknowledges the concerns raised in submissions. It notes that it is not uncommon for resolution mechanisms to be governed by the law applying to the issuer where the other provisions are governed by the law of another jurisdiction. APRA's policy objective will be met by requiring Australian law to apply only to the terms and conditions of capital instruments implementing the loss absorption and non-viability requirements. APS 111 has been amended to reflect this. APRA notes that there is precedent for this approach: ADI capital instruments have been issued where Australian law governs liquidation provisions.

2.2.3 Application of non-viability at the group level

Comments received

Submissions questioned the application of non-viability proposals at Level 2 and, in particular, the proposed requirements for instruments issued by subsidiaries to include non-viability provisions that can be triggered by APRA as well as host regulators. It was submitted that these non-viability triggers should be exercised only by the host regulator to avoid any conflict in regulatory requirements and the consequent difficulties in framing an instrument's terms or describing the level of risk to investors.

APRA's response

Under the Basel III reforms, the relevant jurisdiction in determining a trigger event is the jurisdiction in which the capital instrument is recognised for regulatory purposes. Capital issued by a consolidated subsidiary that is to be included on a solo (Level 1) and group (Level 2) basis must specify an additional trigger event empowering the consolidated supervisor to determine non-viability requiring conversion/write-off. APRA's non-viability requirements reflect this approach.

2.2.4 Guidance on triggering non-viability

Comments received

Several submissions sought guidance on the factors APRA was likely to consider in triggering the non-viability provisions.

APRA's response

It is not possible to define in advance the circumstances or factors that would lead APRA to conclude that an ADI has become 'non-viable'. Nonetheless, APRA is considering whether it may be helpful to provide broad guidance.

2.2.5 Tax effects

Comments received

Several submissions were concerned by APRA's proposal that ADIs should account for taxation liabilities in determining the amount of Common Equity Tier 1 Capital that would arise if loss absorption or non-viability requirements were triggered. A particular concern was that this obligation will also apply to the 'fail-safe' write-off provision mandated by APRA to come into effect should conversion not take place as anticipated. It was suggested that the likelihood of conversion failing and a net tax liability on write-off occurring at the point of non-viability is so remote as to make it unreasonable to discount potential taxation liabilities at the date of issuance. Submissions argued that accounting for these potential tax liabilities at the time of issuance would make these instruments uneconomical.

APRA's response

APRA accepts the argument that triggering the fail-safe write-off provision is highly unlikely. Therefore, ADIs do not need to account for the potential tax liabilities that may be involved. However, where write-off is the primary rather than the fail-safe non-viability or loss absorption mechanism, tax liability and other haircuts must be accounted for from the date of issue.

2.2.6 'Write-up'

Comments received

Some submissions suggested that other jurisdictions may allow instruments to be written-up if an ADI's financial situation improves.

APRA's response

The Basel III framework does not allow write-up and APRA will not be altering its position.

2.2.7 Dilution floor

APRA has imposed a dilution floor, such that the maximum conversion ratio is based on 20 per cent of the share price at issuance. This is a relaxation from the 50 per cent floor applicable in APRA's Basel II prudential standards.

Comments received

Several submissions suggested that the 20 per cent dilution floor be removed or, alternatively, periodically adjusted to reflect other capital structure adjustments such as discounted rights issues. Currently, the share price can only be adjusted for non-cash share reconstructions (e.g. bonus shares, share splits).

APRA's response

APRA's position on the dilution floor was set out in its September 2011 discussion paper and March 2012 response paper. Allowing further adjustments would unnecessarily complicate the calculation of the number of shares to be issued. APRA is therefore retaining its requirement for conversions to be subject to a 20 per cent dilution floor. This also applies to any conversion provisions other than the loss absorption and non-viability requirements.

2.2.8 Conversion into listed shares

Comments received

APRA's proposal that instruments must convert into listed shares prompted a number of submissions. These queried the practical operation of this requirement where there is no listed institution in the group or where the capital has been issued by a non-listed institution to a listed parent (in which case, conversion would result in the listed parent holding its own shares).

APRA's response

APRA intends to retain its general requirement that conversion of non-common equity instruments must be into listed shares. However, APRA will allow conversion into unlisted equity in the following circumstances:

- where there is no listed upstream entity in the relevant group; or
- where the ADI's non-common equity instrument is issued to its listed parent entity.

2.3 Internal Capital Adequacy Assessment Process

Comments received

Submissions acknowledged the importance of the ICAAP regime but raised some concerns about:

- the proposed requirement for a new ICAAP summary statement and an ICAAP report. One submission proposed a single report satisfying Board and APRA requirements;
- the level of detail required in the ICAAP report, suggesting that this requirement will be costly and introduces a risk of the ICAAP becoming a formulaic compliance requirement rather than a Board-driven process. Of particular concern was the proposal to provide detailed information on projected capital levels and planned outcomes and to require a reconciliation of actual outcomes with previous ICAAP reports; and

- the implementation date for the new requirements. One submission requested that the new rules only apply to ICAAP reports written after 1 January 2013. Another submission sought a 'reasonable and adequate' timeframe to meet the expanded obligations.

Submissions also queried:

- the meaning of 'material risks' and 'financial soundness';
- whether an external consultant must be engaged to review the ICAAP; and
- the level of materiality to be applied to the accuracy component of the declaration by the Chief Executive Officer.

APRA's response

APRA has not mandated that the ICAAP summary statement and ICAAP report be contained in separate documents, or that they be prepared specifically for APRA. Indeed, APRA views the ICAAP as being fundamentally owned and driven by the Board. If an ADI chooses to do so, it may address APRA's requirements in a single document, provided all prudential requirements are met. This includes the requirement that the ICAAP report must be updated each year, whereas the summary statement may have a longer life. APRA has clarified these issues in the draft *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and supervisory review* (CPG 110) released for public consultation. APRA has also amended APS 110 to provide that the Board must attest to the accuracy of the ICAAP 'in all material respects'.

An ICAAP necessarily involves calculation and assessment of projected capital levels and planned outcomes. APRA does not agree that incorporating these requirements into APS 110 is unreasonable. APRA is also of the view that making comparisons with previous projections and planned outcomes is a key control mechanism.

APRA confirms that the revised requirements will apply to ICAAP reports that are produced from 1 January 2013, when APS 110 comes into effect. These measures build upon existing requirements and APRA does not see any need for transitional arrangements. That said, an ICAAP should be constantly evolving, and APRA views its new requirements as part of that evolution. An ADI may discuss its incorporation of APRA's requirements with its responsible supervisor.

Within a principles-based regulatory regime, ADIs are better placed to identify their material risks than APRA and 'the expected level of financial soundness' refers to the targeted probability of capital sufficiency as determined by the ADI.

Draft CPG 110 clarifies that a range of reviewers may be utilised as part of the independent review process. For example, a regulated institution may make use of internal audit, external audit, risk management personnel or external consultants to undertake aspects of the review. APRA does not require the review to be undertaken by an external party. Internal resources may be appropriate where it can be demonstrated that they have the requisite skills and operational independence.

Chapter 3 – Regulatory adjustments to capital

APRA has taken account of requests for clarification in this area and minor amendments have been made to the final prudential standards released with this paper. One new concern was raised and is discussed below.

3.1 Funding of an ADI's own shares

APRA's March 2012 response paper noted that the Basel III criteria for Common Equity Tier 1 Capital excludes shares that have been directly or indirectly funded by the ADI.

Comments received

Several submissions were received on indirect funding of an ADI's own equity holdings through margin lending and other similar business. The submissions argued that:

- in a margin lending facility, an ADI's primary exposure is to the creditworthiness of the borrower. An ADI's risk of loss because of a decline in value of its own shares occurs only if the borrower defaults and where realisation of collateral principally necessitates the liquidating of those shares;
- margin lending customers typically have well-diversified and well-collateralised portfolios. An ADI providing margin loans:
 - has assessed the exposure through its normal credit processes before advancing funds;
 - has initial access to the diversified pool of collateralised assets to recover the loan value and the value of its own shares in that pool is likely to be modest;
 - may obtain additional collateral as the borrower's creditworthiness or the value of the collateral pool declines; and
- lending secured by collateral that includes an ADI's own shares should not be treated more harshly than unsecured lending.

Submissions also highlighted the practical difficulties in ADIs identifying holdings of their own securities, particularly for indirect holdings. It was argued that the compliance costs would significantly outweigh any prudential benefits given that the amounts involved are immaterial.

Submissions also proposed alternative methods of calculating capital with respect to margin lending and similar business.

APRA's response

APRA supports the Basel Committee's principle that an ADI cannot directly or indirectly fund holdings of its own capital instruments. APRA notes, however, that this requirement is primarily directed at structures that clearly seek to abuse or arbitrage the capital framework and not at activities that fall into the normal provision of banking services to customers.

Thus, APRA will not require an exclusion/deduction from regulatory capital for indirect funding of own capital instruments where:

- the ADI has full recourse to the borrower in addition to all the collateral funded by that arrangement; and
- the funding arrangement is provided for the purpose of holding a well-diversified and well-collateralised portfolio of investments.

This may include margin lending and similar business.

Chapter 4 – Capital buffers

Basel III introduces two buffers – a capital conservation buffer and a countercyclical capital buffer – aimed at raising the resilience of the banking system and addressing procyclicality. The objectives are to build capital buffers in individual ADIs and in the banking system that can be used in times of stress, and to achieve the broader macroprudential goal of protecting the banking system from periods of excess credit growth.

4.1 Capital conservation buffer

4.1.1 The profits test and the capital conservation buffer

Comments received

Several submissions queried APRA's proposed retention of the 'profits test', which restricts dividend or interest payments that exceed an ADI's Level 1 or Level 2 after-tax earnings, given that the new capital conservation buffer also restricts dividend or interest payments. It was noted that one credit rating agency has indicated that APRA's profits test will cause a one-notch downgrade in the rating of Additional Tier 1 and Tier 2 instruments.

APRA's response

As outlined in its letter to industry of 4 September 2012¹³, APRA remains of the view that requiring prior approval for planned capital reductions arising from ordinary share dividends is a valuable supervisory tool. APRA sees the profits test as a complement to the conservation buffer, providing a flexible, forward-looking and potentially earlier mechanism for supervisory intervention.

However, taking into account submissions received and the fundamental Basel III changes to the nature and required levels of non-common equity capital, APRA now considers that the costs associated with the profits test for Additional Tier 1 and Tier 2 instruments are likely to outweigh the supervisory benefits. APS 110 has therefore been amended to remove the profits test requirement in relation to those instruments.

¹³ *Basel III capital – reductions in capital*: www.apra.gov.au/adi/Documents/120904_Basel_III_reductions_in_capital_letter.pdf

4.2 Countercyclical capital buffer

4.2.1 Application

Comments received

Two submissions queried whether the countercyclical capital buffer would apply equally to all ADIs, including those not involved in providing credit.

Submissions also argued that APRA's March 2012 proposal to exclude purchased payment facilities (PPF) providers from any countercyclical capital buffer indicated a level of flexibility in the Basel III framework that could extend to ADIs that do not provide credit.

APRA's response

The countercyclical capital buffer is neither intended to penalise individual institutions nor to apply only to those institutions that have contributed to, or benefitted from, excess credit growth. It is a macroprudential tool that aims to ensure that the banking system overall is appropriately capitalised. As the Basel Committee recognises, 'banks can suffer the consequences of a period of excess credit, even if they have not directly driven its growth'¹⁴.

APRA also notes that PPF providers are restricted from carrying on a wide range of banking activities, including accepting deposits. They are not subject to many aspects of the existing Basel II capital framework under APRA's prudential requirements¹⁵. APRA's proposal to exempt them from the countercyclical capital buffer is consistent with its long standing treatment of this particular class of ADI and is not grounds for departing from the Basel III approach for other types of ADI.

¹⁴ Basel Committee, *Guidance for national authorities operating the countercyclical capital buffer*, December 2010, www.bis.org/publ/bcbs187.htm, p10.

¹⁵ Refer to Prudential Standard APS 610 Prudential Requirements for Providers of Purchased Payment Facilities.

Chapter 5 – Leverage ratio

Comments received

APRA received one submission on the leverage ratio, which proposed that deposits held with other ADIs or the Reserve Bank of Australia and holdings of Commonwealth Government Securities should be excluded from the definition of exposure. The rationale was that these items do not constitute leverage and do not contribute to aggregated leverage in the banking system. The submission requested that APRA undertake further consultation on the design and implementation of the leverage ratio.

APRA's response

As stated in the March 2012 response paper, the leverage ratio will not migrate to a Pillar 1 requirement until 1 January 2018, with disclosure requirements coming into effect from 1 January 2015. A parallel run period will operate from 1 January 2013 until 1 January 2017, during which the key obligation on ADIs will be reporting rather than compliance.

APRA is proposing to implement the leverage ratio in accordance with Basel III requirements. The leverage ratio is a simple, non-risk-based measure based on items represented on the accounting balance sheet. There is no supervisory discretion in the Basel III framework to exclude the items suggested above and APRA does not propose doing so.

Chapter 6 – Transitional arrangements

The Basel Committee set out detailed transitional arrangements for implementing its reforms so that the global banking system can meet the higher capital requirements through reasonable earnings retention and capital raising, while still supporting lending to the economy. APRA noted in its September 2011 discussion paper and March 2012 response paper that ADIs in Australia are well placed to meet the new requirements and it therefore proposed to accelerate the transition timetable in some areas. Except for one minor change outlined in section 6.2 below, the accelerated timetable remains as proposed in March 2012.

APRA's proposed transitional arrangements were set out in draft APS 160, released for consultation in March 2012. For ease of use, these transitional arrangements have now been included in a new Attachment K to APS 111, making the draft APS 160 redundant.

6.1 Non-complying instruments

As set out in the March 2012 response paper and draft APS 160, an ADI must determine the base amount of Additional Tier 1 and Tier 2 instruments that do not meet the Basel III eligibility criteria (non-complying instruments) at 1 January 2013. It was proposed that ADIs use the Australian dollar value of foreign currency-denominated instruments at that date.

Comments received

One submission recommended that the base amount for certain foreign currency hybrids classified as accounting equity and measured at historical cost should be reflected at the value as presented on an ADI's balance sheet at 1 January 2013 (and not based on the foreign exchange spot rate as at 1 January 2013)¹⁶. It was suggested that this approach would avoid the double-counting of the foreign currency impact in capital and ensure that the capital treatment of the foreign currency hybrid is unaffected by the accounting classification (i.e. debt or equity).

¹⁶ AASB121 *The Effects of Changes on Foreign Exchange Rates* is silent on how to translate foreign currency denominated equity instruments (e.g. hybrids). Hence, an ADI may choose to use either the *historical rate* or the *closing rate* for these instruments. The closing rate would be used when the instrument is measured at fair value.

APRA's response

APRA accepts this recommendation and the final transitional arrangements in Attachment K to APS 111 have been revised accordingly.

6.2 Capital issued by consolidated subsidiaries and held by third parties

Comments received

Submissions sought clarification about the proposed transitional arrangements for capital issued by consolidated subsidiaries and held by third parties.

APRA's response

APRA confirms that the transitional arrangements provided under the Basel III framework that will apply to capital instruments issued by consolidated subsidiaries will depend on whether the instrument complies with the eligibility criteria for inclusion in regulatory capital set out in APS 111, or is non-complying.

For capital instruments that comply with the eligibility criteria, the Basel III requirement is to exclude, at Level 2, surplus capital attributable to third party holders of capital instruments issued by consolidated subsidiaries¹⁷. However, the Basel Committee acknowledges that many jurisdictions (including Australia) currently allow these surplus amounts to be included in regulatory capital and the Basel III rules text allows these amounts to be phased out over five years from 1 January 2013.

The only capital instruments currently on issue from consolidated subsidiaries that satisfy the APS 111 eligibility criteria are ordinary shares held by third parties (minority interest). The amounts of the surplus attributable to third party holders of these shares are insignificant. Accordingly, APRA believes it would be much simpler to exclude these amounts from regulatory capital in full from 1 January 2013 and not phase them out over five years.

¹⁷ The amount that can be included in Level 2 capital is calculated in accordance with Attachment C to APS 111.

In the case of non-complying instruments issued by consolidated subsidiaries, the Basel III transitional arrangements allow such instruments, if eligible for transition, to be included in an ADI's base amount and phased-out over nine years (or until the first call date), subject to APRA's approval. APRA has clarified its position on transitional arrangements in Attachment K of APS 111.

Chapter 7 – Reporting requirements

In 2012, APRA released a discussion paper, *Implementing Basel III capital reforms in Australia: reporting requirements*, outlining its proposals to:

- align its capital adequacy reporting requirements with the new Basel III measures; and
- introduce a fair value reporting standard.

APRA received two submissions on these proposals.

7.1 ARS 110.0 Capital Adequacy

Comments received

Submissions sought advice on two matters:

- the treatment and reporting of investments in non-common equity capital instruments issued by commercial (non-financial) entities that are not prudentially regulated; and
- the treatment and reporting of intangibles arising from an acquisition.

APRA's response

APRA's view is that investments in non-equity capital instruments issued by commercial entities should be treated as a 'claim (other than equity) on private sector counterparties (other than ADIs, overseas banks and corporate counterparties)' and

- risk-weighted at 100 per cent in accordance with *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)*; or
- for ADIs accredited to use internal-ratings based models, in accordance with *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (APS 113)*.

APRA has not changed its policy on the treatment of intangibles, which comprise goodwill and any other intangible assets arising from an acquisition, net of adjustments to profit or loss arising from 'impairment' of goodwill. APS 111 has been amended to reflect that the amount of equity investments in non-consolidated subsidiaries and the associated intangibles must be deducted from Level 2 Common Equity Tier 1 Capital.

7.2 ARS 111.0 Fair Values

Comments received

Submissions requested that APRA mirror the accounting requirements in *AASB 13 Fair Value Measurement (AASB 13)* in ARS 111.0. It was submitted that aligning regulatory and financial accounting requirements would avoid additional regulatory reporting costs for ADIs.

In particular, submissions recommended that APRA not extend its fair value collection of items in Level 3¹⁸ to items in Levels 1 and Level 2 of the fair value hierarchy and claimed that APRA's proposed requirement to report gross unrealised gains separately from gross unrealised losses would require significant changes to accounting and reporting systems. Furthermore, it was stated that it would be impractical to report unrealised gains (losses) on derivative assets separately from derivative liabilities. This is because a derivative can be an asset in one accounting period and a liability in another period. One submission also proposed semi-annual reporting as opposed to quarterly reporting for ARS 111.0.

Finally, submissions sought clarification as to whether the reporting form in ARS 111.0 would be subject to audit requirements under *Prudential Standard APS 310 Audit and Related Matters (APS 310)* from 31 March 2013 onwards.

¹⁸ Level 1 fair values are determined using inputs that are quoted prices in active markets. Level 2 fair values are determined using inputs that are other than quoted prices that may be observed directly or indirectly. Level 3 fair values are determined using unobservable inputs.

APRA's response

The Basel III rules text removes regulatory filters for unrealised fair value gains and losses. It is therefore essential that fair values included in Common Equity Tier 1 Capital are reliable, particularly because financial instruments that are fair valued based on Level 2 inputs form a significant proportion of many ADIs' balance sheets. Globally, during the financial crisis there was an increase in the proportion of instruments valued based on Level 2 and Level 3 inputs and the classification of items in the fair value hierarchy may sometimes be ambiguous¹⁹.

APRA considers transparency of the quality of Common Equity Tier 1 Capital to be of fundamental importance to its supervision and will retain the form in ARS 111.0 as originally proposed, with the enhanced reporting requirements for Level 1 and 2 items as well as the separate reporting of cumulative gross unrealised gains from cumulative gross unrealised losses. In addition, reporting will apply on a quarterly basis as ARS 110.0 and ARS 111.0 are complementary and it is important that their reporting periods are aligned.

However, APRA will allow ARS 111.0 to be completed on a 'best endeavours' basis using existing systems until AASB 13 takes effect for annual reporting periods beginning on or after 1 January 2013. Similarly, ARF 111.0 will not be subject to the audit requirements set out in APS 310 until the public reporting requirements of AASB13 come into effect for annual reporting periods commencing on or after 1 January 2013. APRA intends to amend APS 310 to include ARS 111.0 as a reporting requirement to be audited from that date.

APRA accepts the argument that a derivative can be an asset in one accounting period and a liability in another period and has amended the reporting instructions in ARS 111.0 accordingly.

¹⁹ For further information refer to the Basel Committee Paper *Fair value measurement and modeling: An assessment of challenges and lessons learned from the market stress* (pages 2 and 3). This document is available at: www.bis.org/publ/bcbs137.htm.

Chapter 8 – Remaining Basel III measures

The Basel III measures relating to risk coverage also include measures to reduce reliance on external credit ratings and to minimise cliff effects arising from guarantees and credit derivatives.

8.1 External credit assessment institutions (ECAIs)

Most of the Basel III requirements on the use of ECAIs are already reflected in APRA's prudential standards and *Guidelines on Recognition of an External Credit Assessment Institution* (the ECAI guidelines)²⁰.

However, the Basel III rules text imposes additional criteria, including increased transparency and disclosure for the use of ECAIs for prudential purposes, based on the International Organisation of Securities Commission's *Code of Conduct Fundamentals for Credit Rating Agencies*. The requirements address:

- international access/transparency: the individual assessments, key elements underlying assessments and whether the issuer participated in the assessment process should be publicly available on a non-selective basis, unless they are private assessments. In addition, the general procedures, methodologies and assumptions for arriving at assessments used by the ECAI should be publicly available; and
- disclosure: an ECAI should also disclose:
 - its code of conduct; and
 - the general nature of its compensation arrangements with assessed entities.

APRA proposes to amend its ECAI Guidelines to incorporate these requirements. In particular, paragraph 19 of Annex 1 of the Guidelines will include the requirement to disclose an ECAI's code of conduct and general nature of its compensation arrangements; the remaining requirements will be captured in paragraph 15 of Annex 1.

In relation to the operational requirements for use of external credit assessments used in securitisations:

- an eligible credit assessment, procedures, methodologies, assumptions and the key elements underlining the assessment must be publicly available, on a non-selective basis and free of charge. In other words, a rating must be published in an accessible form and included in the ECAI's transition matrix²¹; and
- loss and cash-flow analysis as well as sensitivity of ratings to changes in the underlying ratings assumptions should be publicly available. Consequently, ratings that are made available only to the parties to a transaction will not satisfy this requirement.

APRA proposes to amend paragraph 9 of Attachment B to draft *Prudential Standard APS 120 Securitisation* released for consultation in August 2012 to reflect these requirements.

8.2 Minimising cliff effects arising from guarantees and credit derivatives

Under the existing Basel II capital framework, 'eligible guarantors' are either 'externally rated A- or better' or 'internally rated and associated with a probability of default (PD) equivalent to A- or better'. A guarantor that falls under this threshold can cause the 'cliff effect' of a material change in regulatory capital requirements.

Under Basel III, credit protection provided for non-securitisation exposures will be recognised where 'other entities' providing the protection are externally rated. When credit protection is provided to a securitisation exposure, 'other entities' that are currently rated BBB- or better and that were externally rated A- or better at the time the credit protection was provided will be recognised.

²⁰ January 2008: www.apra.gov.au/adi/Documents/cfdocs/Final-ECAI-Guidelines.pdf

²¹ A transition matrix is a table of probabilities representing the likelihood, over a given time horizon, of a rating grade of a securitisation exposure migrating to other rating grades, remaining the same or experiencing default.

APRA proposes to implement these changes by amending paragraph 3 of Attachment G to draft *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* released in August 2012.

Under the foundation internal ratings-based substitution approach, the range of eligible guarantors is the same as under the standardised approach except that corporate counterparties that are internally rated may also be recognised under the foundation approach. APRA proposes to amend paragraph 51 of Attachment B to draft APS 113 released in August 2012 to remove the reference to an A- or better requirement.

APRA does not expect these changes to materially affect ADIs in Australia, which do not engage to the same extent in structured credit activities as do banking institutions in some other jurisdictions. APRA invites submissions on these proposals, including an estimate of any implementation costs. Respondents should make use of the Business Cost Calculator described in APRA's previous discussion and response papers on the Basel III capital reforms.



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