



Discussion Paper

Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures

August 2012

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Preamble

This discussion paper outlines proposals by the Australian Prudential Regulation Authority (APRA) to strengthen the counterparty credit risk capital framework for authorised deposit-taking institutions (ADIs) in Australia. These proposals will allow for full implementation of the reforms announced by the Basel Committee on Banking Supervision in December 2010 to strengthen global capital rules so as to promote a more resilient global banking system. These reforms were set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* and are known as 'Basel III'.

Since December 2010, the Basel Committee has made further refinements to its counterparty credit risk requirements, the latest being the interim rules set out in *Capital requirements for bank exposures to central counterparties*, released on 25 July 2012.

The counterparty credit risk proposals set out in this paper also reflect a commitment by G-20 countries (of which Australia is a member) to undertake significant reforms to the functioning of over-the-counter (OTC) derivatives markets, including the commitment to provide capital incentives to move OTC derivative contracts to central counterparties and increase capital requirements for uncleared transactions.

As foreshadowed in its September 2011 discussion paper *Implementing Basel III capital reforms in Australia* and its March 2012 response to submissions, and as outlined in this discussion paper, APRA is also releasing for public consultation draft prudential and reporting standards incorporating other measures to implement the Basel III capital reforms. APRA has also taken the opportunity to clarify some anomalies in these standards that are unrelated to the Basel III reforms.

Concurrently with this paper, APRA is releasing for public consultation the following draft prudential standards and prudential practice guides that incorporate the proposals outlined above – proposed changes in these accompanying draft documents have been highlighted in yellow:

- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112);*
- *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (APS 113);*
- *Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116);*
- *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs) (APS 117);*
- *Prudential Standard APS 120 Securitisation (APS 120);*
- *Prudential Standard APS 220 Credit Quality (APS 220);*
- *Prudential Standard APS 222 Associations with Related Entities (APS 222);*
- *Prudential Practice Guide APG 112 Standardised Approach to Credit Risk (APG 112); and*
- *Prudential Practice Guide APG 113 Internal Ratings-based Approach to Credit Risk (APG 113).*

Reflecting the proposed changes to these prudential standards, APRA is also releasing for consultation proposed changes to the following reporting standards:

- *Reporting Standard ARS 112.1 Standardised Credit Risk – On-balance Sheet Assets (ARS 112.1);*
- *Reporting Standard ARS 112.2 Standardised Credit Risk – Off-balance Sheet Exposures (ARS 112.2);*
- *Reporting Standard ARS 113.4 Internal Ratings-based Approach (IRB) to Credit Risk – Other Assets, Claims and Exposures (ARS 113.4);*
- *Reporting Standard ARS 116.0 Market Risk (ARS 116.0);*
- *Reporting Standard ARS 117.0 Repricing Analysis (ARS 117.0);*
- *Reporting Standard ARS 120.0 Standardised Approach – Securitisation (ARS 120.0); and*
- *Reporting Standard ARS 120.1 Internal Ratings-based (IRB) Approach – Securitisation (ARS 120.1).*

APRA invites written submissions on its proposals. Following consideration of submissions received, APRA will issue final prudential standards and reporting requirements in late 2012. APRA intends to implement the Basel III counterparty credit risk capital requirements and the additional measures from 1 January 2013.

This discussion paper, the draft prudential standards, prudential practice guides and reporting forms are available on APRA's website at www.apra.gov.au. Written submissions on the counterparty credit risk proposals should be made by 28 September 2012 and on the other amendments by 7 September 2012. They should be forwarded by email to Basel3capital@apra.gov.au and addressed to:

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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 such requests, if any, 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

ADI	Authorised deposit-taking institution
Adjusted CEA	Adjusted credit equivalent amount. This is the CEA adjusted for incurred CVA (refer to section 5.3 for more details).
Advanced ADIs	ADIs approved to use the advanced Basel II approaches to measuring risk for capital adequacy purposes
APRA	Australian Prudential Regulation Authority
APG 112	<i>Prudential Practice Guide APG 112 Capital Adequacy: Standardised Approach to Credit Risk</i>
APG 113	<i>Prudential Practice Guide APG 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk.</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 116	<i>Prudential Standard APS 116 Capital Adequacy: Market risk</i>
APS 117	<i>Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)</i>
APS 120	<i>Prudential Standard APS 120 Securitisation</i>
APS 121	<i>Prudential Standard APS 121 Covered Bonds</i>
APS 220	<i>Prudential Standard APS 220 Credit Quality</i>
APS 222	<i>Prudential Standard APS 222 Associations with Related Entities</i>
ARS 112.1	<i>Reporting Standard ARS 112.1 Standardised Credit Risk – On-balance Sheet Assets</i>
ARS 112.2	<i>Reporting Standard ARS 112.2 Standardised Credit Risk – Off-balance Sheet Exposures</i>
ARS 113.4	<i>Reporting Standard ARS 113.4 Internal Ratings-based Approach (IRB) to Credit Risk – Other Assets, Claims and Exposures</i>
ARS 116.0	<i>Reporting Standard ARS 116.0 Market Risk</i>
ARS 117.0	<i>Reporting Standard ARS 117.0 Repricing Analysis</i>
ARS 120.0	<i>Reporting Standard ARS 120.0 Standardised Approach – Securitisation</i>
ARS 120.1	<i>Reporting Standard ARS 120.1 Internal Ratings-based (IRB) Approach – Securitisation</i>
AVC	Asset Value Correlation
Basel III	<i>Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011, 1 June 2011, and Capital requirements for bank exposures to central counterparties, 25 July 2012.</i>
Basel Committee	Basel Committee on Banking Supervision
BCC	Business Cost Calculator

CCP	Central counterparty - a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts.
CDS	Credit default swap
CEA	Credit equivalent amount, as defined in APS 112, which corresponds to the term 'exposure at default' (EAD) in APS 113.
Clearing member	A member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.
Client of a clearing member	A party to a transaction with a CCP through either a clearing member acting as a financial intermediary, or a clearing member guaranteeing the performance of the client to the CCP.
CPSS-IOSCO	Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), which are jointly responsible for setting standards for the supervision and oversight of CCPs.
Custodian	A trustee, agent, pledgee, secured creditor or any other person that holds property in a way that meets the following conditions: <ul style="list-style-type: none"> • the custodian does not have a beneficial interest in that property; and • the property will not become subject to legally-enforceable claims by either the custodian or its creditors, or to a court-ordered stay of the return of such property, should the custodian become insolvent or bankrupt.
CVA	Credit Value Adjustment
Default funds	These funds, also known as clearing deposits or guaranty fund contributions (or any other names), are clearing members' funded or unfunded contributions towards, or underwriting of, a CCP's mutualised loss-sharing arrangements. The description given by a CCP to its mutualised loss-sharing arrangements is not determinative of its status as a default fund; rather, the substance of such arrangements will govern its status.
EAD	Exposure at default, as defined in APS 113, which corresponds to the term 'credit equivalent amount' (CEA) in APS 112.
EL	Expected losses

Exchange-traded	An exchange-traded derivative is one that is traded directly through an exchange, rather than negotiated between two parties.
G-20	Group of Twenty
Internal Model Method (IMM)	Under both the existing Basel framework and Basel III, banks with approval to use the Internal Model Method may use their internal model to estimate Exposure at Default for counterparty credit risk for capital purposes. The IMM is not currently part of APRA's prudential framework.
Initial margin	A clearing member's or client's funded collateral posted to the CCP to mitigate the Potential Future Exposure (PFE) of the CCP to the clearing member arising from the possible future change in the value of their transactions. For the purposes of this discussion paper, initial margin does not include contributions to a CCP for mutualised loss-sharing arrangements (i.e. if a CCP uses initial margin to mutualise losses among the clearing members, it will be treated as a default fund exposure).
IRB	Internal ratings-based approach to credit risk
LGD	Loss given default
OTC	Over-the-counter. An OTC derivative is a derivative transaction other than an exchange-traded derivative, i.e. negotiated between two parties rather than through an exchange. Some examples are interest rate swaps and forward rate agreements.
PD	Probability of default
PFE	Potential Future Exposure
PPG	Prudential Practice Guide
QCCP	Qualifying CCP. An entity that is licensed to operate as a CCP (including a licence granted by way of confirming an exemption) and is permitted by the CCP's regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO <i>Principles for Financial Market Infrastructures</i> .
SFT	Securities financing transaction
Specific wrong-way risk	An ADI is exposed to specific wrong-way risk if future exposure to a specific counterparty is highly correlated with the counterparty's probability of default. For example, a company writing put options on its own stock creates wrong-way exposures for the buyer that is specific to the counterparty.

Standardised ADIs	ADIs using the standardised Basel II approaches to measuring risk for capital adequacy purposes.
Trade exposures	Includes the current exposure and PFE of a clearing member or a client to a CCP arising from OTC derivatives, exchange-traded derivatives transactions or SFTs, as well as initial margin and variation margin payable where the position has gained value but the margin has not yet been paid to the clearing member.
Unadjusted CEA	Unadjusted credit equivalent amount. This is the CEA calculated according to the existing APS 112, i.e. without any adjustment for incurred CVA (refer to section 5.3 for more details).
Variation margin	A clearing member's or client's funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.

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, including reforms to the capital framework for counterparty credit risk. Since then, the Basel Committee has made further refinements to its counterparty credit rules, the latest being the interim rules set out in *Capital requirements for bank exposures to central counterparties*, released on 25 July 2012. This discussion paper commences APRA's public consultation on these Basel III counterparty credit risk capital reforms.

APRA seeks to ensure that its prudential capital framework is consistent with global standards. APRA therefore proposes to adopt the minimum Basel III requirements for the definition and measurement of counterparty credit risk capital, except in certain areas where there are strong pragmatic reasons to either allow for a simplified approach or continue APRA's existing approach.

A summary of the key proposals is provided below.

Additional components of counterparty credit risk capital

Under the existing prudential framework, an ADI that has transacted in OTC derivatives is required to meet a default risk capital requirement in respect of its counterparty credit risk exposures. The Basel III reforms introduce an additional capital charge for bilateral transactions, known as the Credit Value Adjustment (CVA) risk capital charge. Hence, the capital framework for counterparty credit risk for bilateral transactions is to be the sum of:

- the existing counterparty credit default component; and
- the CVA risk capital charge.

The Basel III reforms also introduce capital charges for exposure to central counterparties (CCPs) arising from OTC derivatives, exchange-traded derivatives and securities financing transactions (SFTs). The changes are consistent with the G-20 commitment to clear all standardised OTC derivatives contracts through CCPs. The capital framework for counterparty credit risk in respect of CCPs is to be the sum of:

- a counterparty credit default component in respect of trade exposures; and
- a capital charge for default fund exposures to CCPs. This capital charge is only applicable to ADIs that are clearing members of the CCPs, and have either funded or unfunded commitments to those CCPs.

In determining these capital charges, the Basel III reforms make distinctions between exposures to qualifying CCPs (QCCPs) and non-qualifying CCPs, and apply different capital treatments to:

- a clearing member's trade exposures to a CCP;
- a client's trade exposures to a clearing member of a CCP;
- a clearing member's exposure to its client; and
- collateral posted to a CCP.

APRA intends to apply the Basel III capital framework for counterparty credit risk to:

- ADIs approved to use the Basel II approaches to measuring risk for capital adequacy purposes (Advanced ADIs);
- subsidiaries of foreign banks;
- clearing members of CCPs; and
- other internationally active ADIs.

However, for pragmatic reasons, APRA proposes that other ADIs may be permitted to use a simplified approach to calculate the CVA risk capital requirement, where APRA accepts, after discussion with the ADI concerned, that the nature and scale of its OTC derivatives usage are such that the resulting counterparty credit risk exposure is not material. For such ADIs, the CVA risk capital requirement is to be calculated as equal to the counterparty credit default capital requirement.

Other changes

Other Basel III reforms include the following changes applicable to advanced ADIs in respect of all credit exposures (not just counterparty credit risk exposures):

- increased asset value correlation (AVC) for advanced ADIs exposures to financial counterparties; and
- qualitative requirements for the calculation of probability of default (PD) for highly leveraged counterparties.

The following changes included in the Basel III reforms apply to all ADIs in respect of their counterparty credit risk exposures:

- allowing ADIs to take into account incurred CVA when determining the credit equivalent amount (CEA) for a counterparty credit risk exposure; and
- minimum qualitative requirements for collateral management.

APRA is also taking the opportunity to consult on the following additional changes:

- guidance for advanced ADIs on the management of counterparty credit risk, including the identification of wrong-way risk, collateral management and OTC position management (set out in the draft *Prudential Practice Guide APG 113: Internal Ratings-based Approach to Credit Risk* (APG 113));
- deductions that under the Basel II capital framework were 50 per cent from Tier 1 and 50 per cent from Tier 2 capital are risk-weighted under Basel III at 1250 per cent;
- Basel Committee amendments relating to international trade finance;
- amendments to accommodate the new covered bonds regime;
- amendments to clarify the treatment of certain securitisation items; and
- other amendments to address anomalies in existing standards.

Internal model method and future reforms to the counterparty credit risk capital framework

APRA does not propose to introduce the internal model method (IMM) into the prudential framework when the Basel III reforms outlined above come into effect in January 2013. However, APRA remains willing to consider the adoption of the IMM in the future and intends to continue to review ADIs' approaches to counterparty credit risk management and measurement during 2013. The implementation of an IMM framework will not occur before July 2014, and will be dependent on APRA being satisfied that the modelling approaches employed in industry are sound and able to adequately measure risk during times of stress.

Consultation with industry and other interested stakeholders

Following consideration of submissions received, APRA will issue final prudential standards, reporting standards and prudential practice guides for implementation from 1 January 2013.

Chapter 1 – 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 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. The review resulted in a minor modification of the treatment proposed in the December 2010 document².

On 25 July 2012, the Basel Committee released interim rules for the Basel III capital treatment for exposures to CCPs³.

In a letter to ADIs on 17 December 2010⁴, APRA expressed its full support for the Basel III reforms and indicated its intention to consult on them in 2011 and 2012. APRA has been consulting on the main elements of the Basel III capital reforms. This discussion paper commences APRA's public consultation on those measures relating to counterparty credit risk.

The Basel Committee's June 2011 and 25 July 2012 documents provide the rules text for the minimum Basel III counterparty credit risk capital requirements. The rules include higher capital requirements for non-centrally cleared contracts and provide for appropriate capitalisation of exposures to CCPs. APRA proposes to incorporate the Basel III counterparty credit risk capital requirements into its prudential standards except in certain areas where there are strong pragmatic reasons either to allow for a simplified approach or continue APRA's current approach.

APRA anticipates that, following consideration of submissions received, it will in late 2012 release final prudential and reporting standards that will give effect to the Basel III capital reforms in Australia.

1.2 Structure of the paper

Chapter 2 outlines APRA's proposals to implement the Basel III CVA capital charge.

Chapters 3 and 4 outline APRA's proposals to implement the Basel III capital treatment of trade exposures to central counterparties and default funds. Details of APRA's proposals for implementation of the other Basel III changes are outlined in Chapter 5.

APRA is also taking the opportunity to consult on amendments to prudential and reporting standards to implement other aspects of the Basel III capital reforms, to give effect to proposals previously announced relating to covered bonds and securitisation, and to address some existing anomalies. Details of these proposals are set out in Chapter 6.

APRA encourages ADIs to submit cost-benefit information about the proposed reforms, as set out in Chapter 7.

1 The December text is at: <http://www.bis.org/bcbs/basel3.htm>.

2 Refer <http://www.bis.org/publ/bcbs189.htm>.

3 Refer <http://www.bis.org/publ/bcbs227.htm>

4 <http://www.apra.gov.au/ADI/upload/20101217-Ltr-to-all-ADIs-re-Basel-III-package.pdf>

Chapter 2 – CVA risk capital charge

Under the existing prudential framework, an ADI that has transacted in OTC derivatives is required to meet a default risk capital requirement in respect of its counterparty credit risk exposures. The Basel III reforms introduce an additional capital charge for bilateral transactions, known as the CVA capital risk charge. Hence, the capital framework for counterparty credit risk for bilateral transactions is to be the sum of:

- the existing counterparty credit risk default component; and
- the CVA risk capital charge.

APRA proposes to adopt the Basel III CVA risk capital charge in addition to the existing default risk capital requirements for counterparty credit risk. The CVA risk capital charge covers the risk of mark-to-market losses ('credit value adjustments') on the expected counterparty credit risk arising from bilateral OTC derivatives. The adoption of a CVA capital charge is in response to the experience of the global financial crisis, during which mark-to-market losses due to CVA were not directly capitalised. Analysis undertaken concluded that around two-thirds of counterparty credit risk losses were due to CVA losses and only about one-third were due to actual defaults. The current framework addresses counterparty credit risk as a default and credit migration risk but does not fully account for market value losses short of default⁵.

2.1 Exposures subject to a CVA risk capital charge

The CVA risk capital charge does not apply to transactions with a qualifying CCP. An ADI is also not required to include in this capital charge securities financing transactions (SFT) unless APRA determines that the ADI's CVA loss exposures arising from SFT transactions are material.

2.2 CVA risk capital charge formula

Regardless of an ADI's approach to calculating CVA, APRA is proposing that the CVA risk capital charge be calculated in a manner consistent with the Basel III rules text.

Where an ADI has OTC derivatives transacted with only one counterparty (and does not recognise CVA hedges), the CVA capital charge equals:

$$K_{CVA} = 2.33 \times W \times M \times D \times CEA^{total}$$

where:

- **W** is the weight mapped to the counterparty according to Table 2.1 below.
- **M** is the weighted average maturity of all OTC transactions with the counterparty, weighted by notional amount and subject to a minimum of one year.
- **D** equals:

$$D = \frac{1 - e^{-0.05M}}{0.05M}$$

(where D is the discount factor based on a continuously compounding interest rate of five per cent per annum, and term to maturity of M years, and e (≈ 2.71828) is the base of the natural logarithm).

- **CEA^{total}** is the total unadjusted credit equivalent amount (see Section 5.3 below).

Table 2.1 Weightings applicable to CVA capital charge formula

Long-term external rating grade	CVA capital risk weighting (%)
1	0.7
2	0.8
3	1.0
4 or unrated	2.0
5	3.0
6	10.0

⁵ Refer <http://www.bis.org/publ/bcbs164.htm>.

Where a counterparty does not have an external rating grade, an advanced ADI must have a documented conservative and consistent process that maps its internal rating for that counterparty into the equivalent long-term credit rating grade.

Attachment C to draft *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) sets out more general formulae that apply where an ADI has OTC derivatives transacted with multiple counterparties and/or recognises CVA hedges.

The formulae are based on an approximation of the observed characteristics of risk arising from exposure to movements in CVA, under a set of simplifying assumptions:

- typically higher credit spread volatility for lower-rated counterparties;
- a flat credit spread term structure, with allowance for discounting of values to the term to maturity;
- the market value sensitivity to credit spread movements varies according to the term to maturity;
- some degree of risk diversification between exposures to different counterparties. This is achieved by modelling each single-name credit spread as being driven by the combination of a systemic factor and an idiosyncratic factor. The correlation between any single-name credit spread and the systemic factor is equal to 0.5; and
- full recognition for single-name credit default swap (CDS) hedges matching the counterparty exposure but only partial recognition for index hedges, which are modelled as being driven by the systemic factor only.

Draft Prudential Practice Guide APG 112 includes example calculations of the CVA risk capital charge.

2.3 Recognition of hedges in the CVA risk capital charge calculation

ADIs may be able to recognise the protection afforded from single-name CDS and index CDS hedges, but only where those hedges are transacted with external counterparties, are used for the purpose of mitigating CVA risk, and are managed as such. For example, if a CDS referencing an issuer is in the ADI's inventory and that issuer also happens to be an OTC counterparty but the CDS is not managed as a hedge of CVA, then that CDS may not be included in the calculation of the CVA risk capital charge.

The only CDS hedges that may be included are single-name CDSs (including sovereign CDSs), single-name contingent CDSs, other equivalent hedging instruments referencing the counterparty directly, and index CDSs. Eligible hedges that are included in the CVA capital charge must not be included in the ADI's market risk capital charge calculation under *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116).

Other types of counterparty risk hedges must not be reflected within the calculation of the CVA capital charge, and these other hedges must be treated as any other instrument in the ADI's inventory for regulatory capital purposes.

Ineligible hedges include, for example, tranching or nth-to-default CDSs and any instrument of which the associated payment depends on cross default (such as a related entity hedged with a reference entity CDS and CDS triggers).

Chapter 3 – Capitalising exposures to qualifying central counterparties

APRA proposes to adopt the Basel III framework in respect of exposures to QCCPs. Under that framework, exposures to CCPs arising from OTC derivatives, exchange-traded derivatives and SFTs will be subject to capital requirements, and the capital requirement applicable to trade exposures to QCCPs will be lower than for corresponding exposures arising from bilateral OTC derivative transactions and to non-qualifying CCPs.

An ADI that is either a clearing member or a client of a clearing member for an exchange-traded derivatives transaction for which the clearing member-to-client leg is conducted under a bilateral agreement, must treat the transaction as an OTC derivative for the purpose of calculating capital requirements.

Standards for the supervision and oversight of CCPs are the responsibility of the Committee for Payments and Settlements and the International Organization of Securities Commissions (CPSS-IOSCO). A qualifying CCP is a CCP based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO *Principles for Financial Market Infrastructures*.

3.1 Capital charge for trade exposures to QCCPs

3.1.1 Clearing member trade exposures to QCCPs

Where an ADI acts as a clearing member to a QCCP, its trade exposures to the QCCP will be exempt from the CVA capital charge, and will be subject to a much lower risk-weight (two per cent) than bilateral exposures, reflecting the assumption of a very low risk of default for a QCCP. The two per cent risk-weight also applies to exposure that arises where the clearing member guarantees that its client will not suffer any loss due to changes in the value of its transactions in the event that the CCP defaults.

3.1.2 Client trade exposures to QCCPs

Where an ADI acts as a client of a clearing member to a QCCP and the ADI's clearing arrangements which prevent loss to the client from:

- default or insolvency of the clearing member;
- default or insolvency of another client of the clearing member; or
- the joint default or insolvency of the clearing member and any of its clients,

then the ADI's trade exposures will receive the same capital treatment as if they were clearing member exposures.

Where the clearing arrangement protects the client from loss in all cases of default and insolvency described above, but not in the case of joint default or insolvency of the clearing member and any of its clients, then a higher risk-weight of four per cent applies.

Where the clearing arrangements do not protect the client from loss from either:

- default or insolvency of the clearing member; or
- default or insolvency of another client of the clearing member,

then the ADI must capitalise the exposure (including the CVA capital charge) as a bilateral exposure to the clearing member.

3.1.3 QCCP clearing member trade exposures to clients

A clearing member's trade exposure to its client must be capitalised as bilateral trades (including CVA capital charge), irrespective of whether the clearing member guarantees the trade or acts as an intermediary between the client and the CCP. However, for this purpose the exposure at default (EAD) may be multiplied by 0.71.

3.2 Capital charges for default fund exposures to QCCPs

The Basel III reforms allow (as an interim measure) a clearing member to a QCCP to choose one of two methods to calculate its capital for default fund contributions to a QCCP. The methods are:

- (i) a risk-sensitive approach on which the Basel Committee has consulted twice over recent years; or
- (ii) a simplified method under which default fund exposures will be subject to a 1250 per cent risk-weight subject to an overall cap based on the volume of an ADI's trade exposures.

Given the interim nature of the rules and to reduce complexity, APRA proposes to implement only the simpler of these two methods. Under this proposal, a clearing member must capitalise its default fund contributions to a QCCP according to the following formula:

$$RWA = \text{Min}\{(2\% \times TE + 1250\% \times DF)(20\% \times TE)\} - 2\% \times TE$$

where:

- **RWA** is equal to the ADI's risk-weighted assets in respect of its default fund exposure to the QCCP
- **TE** is equal to the ADI's trade exposure to the QCCP
- **DF** is equal to the ADI's pre-funded contribution to the default fund of the QCCP

3.3 Treatment of collateral posted for exposures to QCCPs

Collateral posted to a QCCP includes cash, securities or other pledged assets, as well as excess initial or variation margin (over-collateralisation). Any collateral posted must, from the perspective of the ADI posting such collateral, receive the risk-weights that otherwise apply to such assets or collateral under APS 112 or *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113), regardless of the fact that such assets have been posted as collateral. In addition, an ADI must apply risk-weights to collateral reflecting the circumstances under which the collateral is held and the credit worthiness of the entity holding the collateral.

3.3.1 Collateral posted by a clearing member

Collateral included in the definition of trade exposures to a QCCP is subject to a two per cent risk-weight. Collateral posted that is bankruptcy remote from the QCCP is not subject to a capital requirement for counterparty credit risk to the bankruptcy-remote custodian.

3.3.2 Collateral posted by a client of a clearing member

Collateral posted by a client that is held at the QCCP on the client's behalf, and that is not held in a manner bankruptcy remote from the QCCP, is subject to the same risk-weight as applies to the client's trade exposures to the QCCP.

Chapter 4 – Capitalising exposures to non-qualifying central counterparties

APRA proposes to adopt the Basel III rules text in respect of exposures to non-qualifying CCPs. A CCP will be classified as non-qualifying unless it is classified as a QCCP by its supervisor/overseer. Where a CCP is in a jurisdiction that does not have a CCP regulator/overseer applying the CPSS-IOSCO *Principles for Financial Market Infrastructure*, APRA has the discretion to treat a CCP as non-qualifying.

4.1 Capital charge for trade exposures to non-qualifying CCPs

APRA proposes to adopt the Basel III framework in respect of trade exposures to non-qualifying CCPs. Under that framework, an ADI must treat its trade exposures to a non-qualifying CCP as a bilateral exposure, and apply the standardised approach for credit risk (as set out in APS 112) to those exposures.

4.2 Capital charges for default fund exposures to non-qualifying CCPs

Under the Basel III framework, an ADI will be required to apply a risk-weight of 1250 per cent to its funded default fund contributions to a non-qualifying CCP. APRA also has discretion to require an ADI to apply a risk-weight of 1250 per cent to an amount in respect of the ADI's unfunded default fund contributions.

Chapter 5 – Other Basel III counterparty credit risk changes

5.1 Asset value correlation (AVC)

Under the Basel III reforms, an advanced ADI will be required to increase the correlation (R) (described in Attachment B to APS 113) by multiplying it by 1.25 in respect of exposures to financial institutions whose assets exceed USD 100 billion and to unregulated financial institutions (including financial institutions or leveraged funds not subject to prudential solvency regulation). This change applies not just to counterparty credit risk but to all sources of credit risk exposure.

The adoption of an increased correlation factor is in response to the experience during the global financial crisis, which demonstrated that large financial institutions were more interconnected than reflected in the current capital framework and that the asset values of financial firms are, on a relative basis, more correlated than those of non-financial firms⁶.

5.2 Calculation of probability of default (PD) for highly leveraged counterparties

Under the Basel III reforms, an advanced ADI must, when estimating PDs for borrowers that are highly leveraged or whose assets are predominantly traded assets, reflect the performance of the underlying assets based on periods of stressed volatilities. This change applies not just to counterparty credit risk but to all sources of credit risk exposure.

5.3 Adjustment to EAD for incurred CVA

Under the Basel III reforms, an ADI will be allowed to use adjusted CEA in calculating the counterparty credit default risk charge. The adjusted CEA is calculated by reducing the EAD (APS 113) or CEA (APS 112) for counterparty credit risk for a particular counterparty by the incurred CVA (i.e. CVA that has already been recognised by the ADI as an incurred write-down) for that counterparty. However, an ADI will be required to use unadjusted CEA to calculate the CVA capital charge. Incurred CVA will not be permitted to be counted as eligible provisions under APS 113; however, expected losses (EL) can be calculated based on the reduced CEA.

5.4 Minimum collateral management requirements

An ADI must ensure that sufficient resources are devoted to the orderly operation of margin agreements with OTC derivative and securities financing counterparties, as measured by the timeliness and accuracy of its outgoing calls and response time to incoming calls. An ADI must have collateral management policies in place to control, monitor and report:

- the risk to which margin agreements exposes it (such as the volatility and liquidity of the securities exchanged as collateral);
- the concentration risk to particular types of collateral;
- the re-use of collateral (both cash and non-cash), including the potential liquidity shortfalls resulting from the re-use of collateral received from counterparties; and
- the surrender of rights on collateral posted to counterparties.

⁶ Ibid.

5.5 Treatment of securitisation collateral for OTC derivative transactions

The Basel III reforms include increased haircuts for some types of collateral. Haircuts on securitisation exposures will be twice that of other non-sovereign issued debt, while resecuritisation exposures will no longer be eligible financial collateral.

The table below sets out the standardised supervisory haircuts for securitisation exposures (assuming daily mark-to-market, daily remargining and a 10-business day holding period), expressed as percentages:

Table 5.1 Haircuts for securitisation collateral

Credit rating grade for debt securities	Residual maturity	Haircut
1 (long- and short- term)	≤ 1 year	2
	> 1 year, ≤ 5 years	8
	> 5 years	16
2-3 (long- and short-term)	≤ 1 year	4
	> 1 year, ≤ 5 years	12
	> 5 years	24
4 (long-term)	All	Not eligible

5.6 Minimum holding periods to apply when using own-estimate haircuts

Under the Basel III framework, an ADI that has APRA approval to calculate its own exposure and collateral haircuts based on internal estimates of market price and foreign exchange volatilities must apply a higher minimum holding period than the minima set out in Table 11 of Attachment H of draft APS 112, in the following circumstances:

- for all netting sets where the number of trades exceeds 5,000 at any point during a quarter, the minimum holding period must be set to 20 business days for the following quarter; and
- for netting sets containing one or more trades involving either illiquid collateral or an OTC derivative that cannot be easily replaced, the minimum holding period must be set to 20 business days. An ADI must determine both liquidity and ease of replacement in the context of stressed market conditions.

In determining the holding period, an ADI must consider whether trades or securities it holds as collateral are concentrated in a particular counterparty and if that counterparty exited the market precipitously, whether the ADI would be able to replace its trades.

Chapter 6 – Other amendments

In March and June 2012, respectively, APRA released for consultation five draft prudential standards and two draft reporting standards that incorporate the key Basel III capital reforms. As foreshadowed in accompanying discussion papers⁷, some amendments are also required to other prudential and reporting standards to implement the Basel III reforms in Australia. APRA is also proposing to clarify ambiguities and make minor wording and formatting changes in existing standards that are unrelated to the Basel III measures. This chapter outlines these proposed amendments.

6.1 Regulatory adjustments to Common Equity Tier 1 Capital

Basel III applies a number of regulatory adjustments to Common Equity Tier 1 Capital instead of to Tier 1 or Tier 2 Capital, as under the Basel II framework. Most of these adjustments were included in the draft APS 111 released for public consultation in March 2012 and reflected in the draft ARS 110 released in June 2012.

To implement the Basel III measures in full, APRA is also proposing the following amendments:

- deductions that are currently from Tier 1 or Fundamental Tier 1 Capital will be from Common Equity Tier 1 Capital. This applies to:
 - materiality thresholds (paragraph 7, Attachment G and paragraph 13, Attachment I to APS 112 and paragraph 53 of Attachment B to APS 113);
 - the shortfall in provisions for credit losses in paragraph 24 of APS 113;
 - the treatment of spread accounts and similar surplus income arrangements arising from securitisations (paragraphs 21–25 of Attachment B to *Prudential Standard APS 120 Securitisation* (APS 120));
 - derivative transactions where an originating ADI in a securitisation is a net payer for an extended period (paragraph 9 of Attachment E to APS 120); and

- specified provisions, amounts in the General Reserve for Credit Losses, restructured facilities and other items previously deducted from Tier 1 Capital (*Prudential Standard APS 220 Credit Quality* (APS 220));
- paragraph 25 of APS 113 has been amended so that the limit on the amount of any loan loss reserve that may be included in Tier 2 Capital is determined by reference to 'total credit risk-weighted assets' instead of 'total risk-weighted assets';
- item 21 in Class VII, Attachment A to APS 112 and paragraph 12 of Attachment E to APS 113 have been amended to take account of the Basel III requirement incorporated in the draft APS 111 to deduct margin loans used to purchase an ADI's own shares rather than apply a 20 per cent risk-weight; and
- paragraph 5(a)(iii) of *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (*Advanced ADIs*) has been amended to include items included in Common Equity Tier 1 Capital instead of Fundamental Tier 1 Capital in the definition of 'banking book items'.

6.2 Risk-weighted assets

As outlined in its discussion papers, APRA proposes to adopt the Basel III treatment under which certain items, previously deducted 50:50 from Tier 1 and Tier 2 capital, are to be risk-weighted at 1250 per cent. These items are:

- non-payment/delivery on non-delivery-versus payment (DvP) and non-payment-versus-payment (PvP) transactions in Attachment E to APS 112;
- the treatment of certain securitisation exposures in *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116⁸), namely:
 - where no due diligence on underlying collateral is undertaken (paragraph 11 in Attachment B and paragraph 77 in Attachment C); and
 - where those exposures are of specified credit ratings or are unrated (Attachment B).

⁷ Discussion paper *Implementing Basel III capital reforms in Australia*, September 2011, response to submissions *Implementing Basel III capital reforms in Australia*, March 2012 and discussion paper *Implementing Basel III capital reforms in Australia: reporting requirements*, June 2012. See: <http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-pacages.aspx>

⁸ Under APS 116, securitisation and resecuritisation exposures previously deducted from capital are now subject to the equivalent risk-weight of 1250 per cent (i.e. a 100 per cent capital charge. Risk-weighted assets are calculated as 12.5 times the capital charge).

Paragraph 14 of Attachment B has also been amended so that positions previously subject to deduction (now subject to a capital charge of 100 per cent) are not excluded from the calculation for general market risk;

- the treatment of certain securitisation exposures in APS 120, namely:
 - those that would be risk-weighted at 1250 per cent if held in the banking book must be risk-weighted at 1250 per cent if held in the trading book (paragraph 7 of APS 120), where no due diligence on underlying collateral is undertaken (paragraph 12 of Attachment B to APS 120);
 - where those exposures are of specified credit ratings or are unrated (Attachments C and D of APS 120);
 - where an advanced ADI is unable to apply any of the hierarchy of approaches outlined in Attachment D to APS 120; and
 - where the risk-weight resulting from the supervisory formula is equal to or greater than 1250 per cent (paragraph 35 in Attachment D to APS 120).

Paragraph 8 of Attachment B to APS 120 (January 2012) and paragraph 36 of Attachment D to APS 120 (January 2012) have been deleted as obsolete.

6.3 Other amendments

APRA is also proposing to make other amendments to the prudential and reporting standards released for consultation with this discussion paper that are unrelated to the Basel III reforms. These amendments are intended to:

- implement further prudential requirements related to covered bonds;
- give effect to changes to the capital treatment of certain securitisation subordinated holdings; or
- clarify existing anomalies.

APRA does not anticipate that these proposals will have any material impact on ADIs.

6.3.1 Covered bonds and other securitisation matters

In 2011, amendments to the *Banking Act 1959* facilitated the issuance of covered bonds by ADIs. APRA's proposed prudential requirements for covered bonds were outlined in its November 2011 discussion paper *Covered bonds and securitisation matters* and its June 2012 response paper *Covered bonds and securitisation matters*⁹. Both of the papers foreshadowed APRA's proposal to amend APS 112 and APS 113 to exclude liabilities of a covered bond special purpose vehicle to an issuing ADI, as specified in *Prudential Standard APS 121 Covered Bonds* (APS 121). Changes to paragraph 7 of draft APS 112 and 113 accompanying this discussion paper are intended to implement this proposal.

The two papers also outlined APRA's proposal to require an ADI to deduct from Common Equity Tier 1 Capital an exposure in the trading or banking book to a subordinated tranche(s) of a securitisation originated by an entity other than the ADI or an extended licensed entity of the ADI. This proposal has been included in a new paragraph 29 of Attachment B to APS 120.

⁹ <http://www.apra.gov.au/adi/Pages/Covered-bonds-and-securitisation-matters-Nov-2011.aspx>

6.3.2 Miscellaneous amendments

APRA is also proposing a number of other minor amendments.

- 'Claims on overseas central banks, including foreign currency claims on the Reserve Bank of Australia' is to be moved from Class III to Class II (item 6) in the list of risk-weights for on-balance sheet assets in Attachment A of APS 112. There is no change in the risk-weights. The proposed change is to more closely align the risk-weighting of claims on central banks with sovereign claims in accordance with the Basel Committee's Basel II terminology. This amendment had been carried through to paragraphs 44 and 45 of APS 113.
- Footnote 11 of APS 112 is to be amended in relation to the risk-weighting of exposures to an unrated ADI, other than exposures related to short-term (maturity of one year or less) self-liquidating letters of credit (both issued and confirmed) used for the purposes of trade financing. This change and the one following reflect a Basel Committee discussion.
- A new paragraph 40 is to be added to Attachment B to APS 113 waiving the one-year maturity floor for letters of credit (both issued as well as confirmed) used for the purposes of trade financing that have a maturity below one-year and are self-liquidating.
- Reference in paragraph 3 of Attachment D to APS 112 is to be changed to reflect recent reforms to consumer credit law under which the *Consumer Credit Code* is now the *National Credit Code*.
- The credit rating mapping grades currently found in APG 112 are to be incorporated in Attachment F to APS 112. These credit grades are used to calculate risk-weights for particular claims under the prudential standard and, as such, the definition of those grades should be located in the standard rather than in a Prudential Practice Guide (PPG).
- Footnote 2 of APS 113 has been clarified to provide that, for the on-balance sheet component, the book value of the exposure is gross of any eligible provisions.
- Paragraph 17 of Attachment B to APS 113 is to be aligned with paragraph 14 in relation to the methodology for determining the Loss given default (LGD) for exposures secured by eligible financial receivables under the foundation internal ratings-based (IRB) approach.
- For EAD for on-balance sheet exposures, paragraph 23 of Attachment B and paragraph 6 of Attachment C to APS 113 are to be amended to refer to the current contractual amount owed by the obligor.
- Footnotes 23 and 24 of Attachment B to APS 113 (capital requirement in respect of unexpected losses for defaulted exposures under the advanced IRB approach) are to be amended to refer to standards for all IRB classes (paragraphs 92 to 94 of Attachment A), and LGD assigned to a defaulted asset (paragraph 98 of Attachment A), respectively. Similar amendments are proposed for footnotes 33 and 34 of Attachment C (capital requirement for defaulted retail exposures) to refer to standards for all IRB classes (paragraphs 92 to 94 of Attachment A), and LGD assigned to a defaulted asset (paragraph 98 of Attachment A), respectively.
- The existing error in paragraph 86 of Attachment B, APS 113 is to be amended such that the probability of default should be to the obligor, not the protection provider.
- The reference to operating leases in paragraph 13 of Attachment E to APS 113 will be deleted as obsolete, given that paragraph 6 requires the residual value of the leased asset to be risk-weighted at 100 per cent.

- The existing transitional provisions in APS 120 will be deleted as obsolete.
- *Guidance Note AGN 220.1 Impaired Facility Definitions, Guidance Note AGN 220.2 Impairment, Provisioning and the General Reserve for Credit Losses, Guidance Note AGN 220.3 Prescribed Provisioning and Guidance Note AGN 220.4 Credit Risk Grading Systems* will be incorporated into APS 220. These Guidance Notes pre-date APRA's policy of incorporating mandatory prudential requirements into prudential standards. They have now been included as Attachments to APS 220. There is no substantive change in their requirements.
- *Prudential Standard APS 222 Associations with Related Entities* is to be aligned with *Prudential Standard APS 221 Large Exposures* by including a provision under which APRA may vary the limits that apply to exposures of ADIs to related parties. There is currently some inconsistency between these standards in that APS 221 has a provision that allows APRA discretion to vary the large exposure limits that apply to an ADI's exposures to (for example) counterparties or groups of counterparties, but no such discretion is provided for in APS 222. This creates a risk that an ADI may have exposures to related entities that are not considered appropriate from a prudential perspective; in the absence of a specific discretion to vary large exposure limits to related entities, APRA's ability to address its prudential concerns is limited.
- All prudential and reporting standards will be updated to:
 - refer to the new *Prudential Standard APS 001 Definitions*;
 - incorporate Basel III terminology for regulatory capital by, for example, referring to 'regulatory adjustments' instead of the current 'deductions'; and
 - standardise language across prudential standards and to reflect statutory terms (for instance, using 'information' instead of 'data' in reporting standards in accordance with the terminology in the *Financial Sector (Collection of Data) Act 2001*).

Chapter 7 – Request for cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties on the financial impact of the proposed Basel III counterparty credit risk capital reforms and any other substantive costs associated with the proposed reforms. These costs could include the impact on balance sheets, profit and loss, and capital.

As part of the consultation process, APRA also requests respondents to provide an assessment of the compliance impact of the proposed changes. Given that APRA's proposed requirements may impose some compliance and implementation costs, respondents may also indicate whether there are any other regulations relating to ADI capital adequacy that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input to the BCC as well as the final result. The BCC can be accessed at www.finance.gov.au/obpr/bcc/index.html.



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