Australian Prudential Regulation Authority

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APRA

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To: All locally incorporated Authorised Deposit-taking Institutions

BASEL III CAPITAL – GOVERNING LAW AND JOINT ARRANGEMENTS

In September 2011, APRA released a discussion paper on its proposals for implementing the Basel III capital reforms in Australia[1]. This was followed in March 2012 by a response to submissions paper and a draft of *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111)[2].

Governing law

This material outlined APRA's intention to adopt the Basel III requirement that, to be included in regulatory capital, all Additional Tier 1 and Tier 2 Capital instruments issued by authorised deposit-taking institutions (ADIs) must include provisions under which the instruments convert to ordinary shares or are written off at the point of non-viability. Additional Tier 1 Capital instruments classified as liabilities under Australian Accounting Standards must also provide for conversion or write-off where the issuing ADI's Common Equity Tier 1 Capital ratio falls below 5.125 per cent of risk-weighted assets (the loss absorption trigger point).

Where an ADI has reached the point of non-viability or the loss absorption trigger point, it will be critical that the subsequent conversion and/or write-off can be implemented with certainty and within a short timeframe under the relevant law. In APRA's view, there would be greater assurance that this will be accomplished if all Additional Tier 1 and Tier 2 Capital instruments were required to be subject to Australian law.

APRA is therefore considering an amendment to draft APS 111 that would state that, to be included as eligible Additional Tier 1 or Tier 2 Capital, 'the instrument must be subject to Australian law'.

This approach has also been proposed for general and life insurers as set out in APRA's May 2012 response to submissions paper *Review of capital standards for general insurers and life insurers*[3].

APRA invites feedback on this proposal. In particular, it invites feedback on any practical difficulties in implementing such a requirement and whether there may be other mechanisms that would provide assurance to APRA of certainty of outcome and the prompt execution of any required conversion and/or write-off of eligible Additional Tier 1 and Tier 2 Capital instruments.

[1] http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-September-2011.aspx
[2] http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-March-2012.aspx
[3] http://www.apra.gov.au/CrossIndustry/Consultations/Documents/LAGIC-Response-to-Submissions-31-May-2012.pdf

Joint arrangements

APRA would also like to clarify the capital treatment and reporting for joint arrangements as a consequence of new accounting requirements in *Australian Accounting Standard AASB 11 Joint Arrangements* (AASB 11). AASB 11 effectively requires 'proportionate consolidation' for joint operators in joint operations; in contrast, joint ventures continue to be accounted for using the 'equity method'.

APRA's intention is that, for capital adequacy purposes under Basel III, joint ventures and joint operations should be treated in exactly the same manner. As a result, APRA proposes that ADIs adopt the same accounting treatment (i.e. equity accounting) for joint operations and joint ventures. This would result in a full deduction of the equity investment as a regulatory adjustment to capital. The proposed *ARF 110.0 Capital Adequacy* reporting instructions have been clarified to give effect to this intention. APRA proposes to amend the final APS 111 to reflect this approach and invites comment on this proposed course of action.

Written submissions on these proposals should be forwarded by 6 July 2012 to: Basel3capital@apra.gov.au and addressed to:

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Yours sincerely

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