



Discussion Paper

Implementing Basel III capital reforms in Australia: reporting requirements


8 June 2012

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Preamble

In September 2011, the Australian Prudential Regulation Authority (APRA) released a discussion paper outlining its proposals to implement measures announced by the Basel Committee on Banking Supervision (Basel Committee) designed to strengthen global capital rules. These measures are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III). In March 2012, in response to the submissions on its proposals, APRA published *Response to submissions: Implementing Basel III capital reforms in Australia*. Also at that time, APRA released for consultation five draft prudential standards to give effect to the reforms set out in the Basel III package.

The Basel III reforms also require an update to certain aspects of APRA's reporting framework. This discussion paper outlines APRA's proposals.

With one exception, the proposed changes reflect the Basel III proposals on which APRA has been consulting. The exception is the result of changes to the *Banking Act 1959* in 2011 facilitating covered bonds and relates to the limit on assets that may be pledged.¹ APRA has also clarified the capital treatment of joint arrangements.

Accompanying this paper are two proposed reporting standards, including draft forms and their associated instructions:

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

APRA invites written submissions on these proposed changes to the reporting framework. Following consideration of submissions received, APRA intends to issue final reporting standards later in 2012 that will come into effect from 1 January 2013, in line with the implementation of the Basel III capital reforms in Australia. For most authorised deposit-taking institutions, this means that the first report under the new reporting standards will be due in April 2013 for the period ending 31 March 2013.

Before the end of September 2012, APRA also intends to release a package outlining the consequential changes to prudential standards and reporting requirements that are necessary to give full effect to the Basel III capital reforms. As indicated in the previous discussion and response papers, APRA will also release for discussion its proposals for implementing the Basel III requirements on counterparty credit risk and revised Pillar 3 disclosures once these are finalised by the Basel Committee.

This discussion paper is available on APRA's website at www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx. Written submissions on the paper should be forwarded by 3 August 2012 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.

¹ Refer to APRA's discussion paper *Covered bonds and securitisation matters*, November 2011: www.apra.gov.au/adi/Pages/Covered-bonds-and-securitisation-matters-Nov-2011.aspx

Contents

Chapter 1 – Introduction	6
Chapter 2 – Changes to capital adequacy reporting	7
2.1 Definition of capital	7
2.2 Categories of capital	7
2.3 Eligible capital	7
2.4 Deductions and adjustments	8
2.5 Adjustments for covered bonds	8
2.6 Treatment of joint arrangements	8
Chapter 3 – Fair value reporting	9
Chapter 4 – Request for cost-benefit analysis information	10

Glossary

AASB 7	<i>AASB 7 Financial Instruments: Disclosures</i>
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 111	<i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i>
APS 160	<i>Prudential Standard APS 160: Capital Adequacy: Basel III Transitional Arrangements</i>
APS 310	<i>Prudential Standard APS 310: Audit and Related Matters</i>
ARF 110.0	<i>Reporting Form Capital Adequacy (Level 1/Level 2)</i>
ARF 110.0.1	<i>Reporting Form ARF 110.0.1 Capital Adequacy (Level 1)</i>
ARF 110.0.2	<i>Reporting Form ARF 110.0.2 Capital Adequacy (Level 2)</i>
ARF 111.0	<i>Reporting Form Fair Values (Level 1/Level 2)</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>
Banking Act	<i>Banking Act 1959</i>
Basel Committee	Basel Committee on Banking Supervision
Basel II	<i>International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version, June 2008</i>
Basel III	<i>Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee, December 2010 (revised June 2011)</i>
D2A	Direct to APRA reporting system

Chapter 1 – Introduction

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) released a paper entitled *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III).² The Basel III framework is designed to improve the quality and consistency of capital in the global banking system.

In September 2011, APRA released a discussion paper outlining its proposals to implement Basel III in Australia.³ This was followed, in March 2012, by a further paper setting out APRA's response to submissions received on the discussion paper.⁴ APRA also released for consultation five draft prudential standards designed to give effect to the Basel III capital reforms.

In both papers, APRA indicated that the Basel III capital reforms would require changes to APRA's reporting standards for both authorised deposit-taking institutions (ADIs) and the consolidated banking groups of which they are a part. This discussion paper and the accompanying draft reporting standards reflect the changes to APRA's capital requirements as a result of the adoption of Basel III. APRA is proposing to adopt the new terminology for, and definitions of, regulatory capital. There are also some changes to regulatory adjustments and transitional arrangements for existing capital instruments that APRA intends to incorporate into the reporting framework. Other than the items relating to covered bonds and clarifying the capital treatment of joint arrangements, the reporting standards do not introduce any additional changes beyond those matters outlined in APRA's two previous papers.

The proposed changes to ADI reporting requirements will involve amendments to the existing *Reporting Standard ARS 110.0 Capital Adequacy* (ARS 110.0) and the associated reporting forms and instructions at both Level 1 and Level 2.

In addition, APRA is proposing to introduce a new *Reporting Standard ARS 111.0 Fair Values* (ARS 111.0) that will include reporting forms and instructions at Level 1 and Level 2. These forms are designed to capture specific details on:

- the fair value hierarchy for assets and liabilities;
- transfers between levels in the fair value hierarchy; and
- the consequent cumulative gross unrealised fair value gains and losses which impact on regulatory capital calculations.

Following consideration of submissions received, APRA will issue final reporting standards and reporting forms later in 2012. The first submission of quarterly data required from ADIs will relate to the reporting period ending 31 March 2013.

² Revised in June 2011: www.bis.org/publ/bcbs189.htm

³ www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-September-2011.aspx

⁴ www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-March-2012.aspx

Chapter 2 – Changes to capital adequacy reporting

2.1 Definition of capital

APRA proposes to amend *Reporting Form ARF 110.0.1 Capital Adequacy (Level 1)* (ARF 110.0.1) and *Reporting Form ARF 110.0.2 Capital Adequacy (Level 2)* (ARF 110.0.2) to reflect the proposed changes in the eligibility criteria of the components of regulatory capital under Basel III and the predominant focus on Common Equity Tier 1 Capital.

2.2 Categories of capital

Under the existing prudential framework, there are four categories of capital: Fundamental Tier 1 capital, Residual Tier 1 capital, Upper Tier 2 capital and Lower Tier 2 capital. Under Basel III, these categories will be replaced with: Tier 1 Capital – consisting of Common Equity Tier 1 Capital and Additional Tier 1 Capital – and Tier 2 Capital. Various changes to ARF 110.0.1 and ARF 110.0.2 are required to reflect the reduction in the number of categories of capital.

2.3 Eligible capital

APRA proposes to retain as many data items and definitions from the current reporting standards as practicable. However, Basel III introduces new components to the categories of capital and amends the definitions of existing components. Some amendments to the ARF 110.0 forms are therefore required. APRA has also taken the opportunity to revise definitions and instructions for existing items as a result of its participation in the Government's Standard Business Reporting program⁵ and to align with its proposed capital measures applying to the general and life insurance industries.

Accordingly, APRA proposes to update the reporting standard, including the ARF 110.0 forms and instructions. For instance:

- new data items capture the new categories of capital, capital eligible for transitional arrangements under *Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements*, and accumulated other comprehensive income (and other reserves);
- APRA has moved away from the use of 'gross' and 'net' and adopted the Basel III approach to 'Total Capital', which is net of adjustments;
- APRA has updated the instructions to reflect its intention to amend the treatment of expected dividends by requiring that only dividends when declared in accordance with Australian Accounting Standards are to be excluded from current year earnings;
- the General Reserve for Credit Losses is now included in Tier 2 (previously in Upper Tier 2) Capital and the limit of the amount that can be recognised is based on total *credit* risk-weighted assets (instead of total risk-weighted assets).

⁵ Refer to www.sbr.gov.au for more information on this program.

2.4 Deductions and adjustments

Under the existing Basel II framework⁶, APRA requires ADIs to deduct specified items from different categories of capital. APRA proposes to adopt the Basel III terminology and require 'adjustments' to capital in place of 'deductions'. As outlined in the September 2011 discussion paper, APRA also proposes to require most adjustments to be made to Common Equity Tier 1 Capital instead of the current deductions from Tier 1 or Tier 2 capital. The proposed ARF 110.0 forms reflect this change.

2.5 Adjustments for covered bonds

Following amendments to the *Banking Act 1959* in 2011, covered bonds may be issued by ADIs subject to certain restrictions. As foreshadowed in its November 2011 discussion paper *Covered bonds and securitisation matters*, APRA proposes that assets held in a covered bond pool (securing covered bonds) in excess of eight per cent of the ADI's assets in Australia, will be deducted from Common Equity Tier 1 Capital. APRA proposes introducing a new line item for this adjustment in both ARF 110.0.1 and ARF 110.0.2.

2.6 Treatment of joint arrangements⁷

APRA proposes to clarify the capital treatment and reporting for joint arrangements as a result of the accounting requirements in *Australian Accounting Standard AASB 11 Joint Arrangements* (AASB 11).⁸ AASB 11 effectively requires 'proportionate consolidation' for joint operators in joint operations.⁹ In contrast, joint ventures¹⁰ continue to be accounted for using the 'equity method'.¹¹

When 'proportionate consolidation' is followed by a joint operation, the ADI may not have freely available access to the assets of the joint operation. Furthermore, the liabilities of a joint operation that are proportionately consolidated may also give rise to a larger exposure from a prudential perspective.

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 reporting instructions have been clarified to give effect to this. APRA will also amend the final *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) to reflect the proposed treatment.

⁶ *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version*: www.bis.org/publ/bcbs128.htm

⁷ Joint arrangements are defined in *Australian Accounting Standard AASB 11 Joint Arrangements* as either a joint venture or a joint operation.

⁸ AASB 11 applies to annual reporting periods beginning on or after 1 January 2013.

⁹ A joint operation is defined in Appendix A of AASB 11 as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

¹⁰ A joint venture is defined in Appendix A of AASB 11 as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

¹¹ Equity method is defined in *Australian Accounting Standard AASB 128 Investments in Associates and Joint Ventures*.

Chapter 3 – Fair value reporting

As set out in its September 2011 discussion paper, APRA will require ADIs to prepare quarterly reports to collect fair value information on assets and liabilities. The reason for this additional reporting requirement is that Basel III allows all unrealised gains and losses recognised on the balance sheet to be included in Common Equity Tier 1 Capital. APRA's view, as noted previously, is that Level 2 and Level 3 inputs of the fair value hierarchy¹² in *Australian Accounting Standard AASB 13 Fair Value Measurement* (AASB 13) are not as reliable as Level 1 inputs for providing evidence of fair value. Therefore, given that for some ADIs Level 2 inputs can represent a significant amount of the balance sheet, APRA intends to require quarterly reporting of cumulative gross unrealised gains and losses for all fair values. This will also allow APRA to undertake more comprehensive analysis of an ADI's Common Equity Tier 1 Capital. This will, among other things, assist APRA to determine the quality of an ADI's Common Equity Tier 1 Capital where there is a significant component of that capital represented by unrealised fair value gains.

Fair value reporting will be required at both the ADI on a stand-alone basis and at the level of the group of which the ADI is a member, as appropriate. A new reporting standard and accompanying forms and instructions are proposed for this purpose.

APRA proposes that ADIs submit fair value information to complement their capital adequacy return from 1 January 2013 onwards. It is proposed that ADIs submit fair value information on a 'best endeavours' basis until AASB 13 is adopted for public reporting for annual reporting periods beginning on or after 1 January 2013.¹³ In APRA's view, reporting on this basis will reduce the industry's reporting burden and will enable ADIs to align their Direct to APRA (D2A) reporting with their AASB 13 implementation timetable.

There will also be subsequent amendments made to *Prudential Standard APS 310 Audit and Related Matters* (APS 310), Attachment A, to add the proposed ARF 111.0 to the list of reporting forms subject to audit for prudential purposes.

12 Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

13 AASB 13 supersedes the existing fair value measurement requirements in *AASB 7 Financial Instruments: Disclosures* (AASB 7) that ADIs presently are required to follow. ADIs are currently already disclosing information on fair value in their annual reports under AASB 7.

Chapter 4 – 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.

As part of the consultation process, APRA requests respondents to provide an assessment of the impact of the proposed changes and, specifically, the marginal compliance costs ADIs are likely to face. Given that APRA's proposed requirements may impose some compliance costs, respondents may also indicate whether there are any other reporting requirements 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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