DISCUSSION PAPER

A more flexible and resilient capital framework for ADIs

8 December 2020

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Executive summary

Capital is the cornerstone of a bank's financial strength. Adequate levels of capital increase the resilience of banks, thereby protecting depositors, maintaining market confidence and promoting financial stability – especially during periods of financial stress.

In Australia, APRA sets capital adequacy requirements for all authorised deposit-taking institutions (ADIs) – banks, building societies and credit unions. With the objective of underpinning the strength of our financial system, APRA's requirements have generally been set higher than internationally agreed minimum standards. The Australian community has benefited from a highly rated and stable financial system as a result.

The 2014 Financial System Inquiry (FSI) endorsed this approach. It also emphasised that, to mitigate the risk of investors withdrawing or reducing access to funding in times of stress, Australian ADIs should be, and be perceived to be, more resilient than international peers. In particular, the FSI recommended that APRA should set capital requirements such that the capital ratios of Australian ADIs were 'unquestionably strong'. This recommendation was endorsed by the Australian Government.

In 2017, APRA set benchmarks for ADI capital ratios under the current capital adequacy framework that could reasonably be considered to be consistent with the 'unquestionably strong' objective. APRA set the industry the task of achieving these benchmarks by the beginning of 2020. These benchmarks were met – fortuitously, ahead of the onset of COVID-19. The economic impact of the pandemic has confirmed the importance and value of a resilient and well capitalised banking system – one that can act as an absorber of economic stress and aid in economic recovery.

While the banking sector has been bolstering its resilience, APRA has in parallel been undertaking a comprehensive review of the ADI capital framework, designed to improve its strength, flexibility, comparability and transparency. The challenges in the current environment have reinforced the importance of finalising this set of reforms as a foundation for the ongoing strength of the Australian financial system.

APRA's objectives

APRA's core objectives in reforming the capital framework are to:

- **deliver 'unquestionably strong' capital ratios**, fulfilling the FSI's recommendation. As ADIs are already meeting the 'unquestionably strong' benchmarks, APRA is not seeking to further increase the overall level of capital in the banking system; and
- **ensure adherence** to the internationally agreed Basel standards.

Beyond these core objectives, APRA is also seeking to make a number of beneficial improvements to the capital adequacy framework across a number of dimensions:

- improving the flexibility of the capital framework. This is proposed to be achieved primarily by increasing the size of regulatory capital buffers, which are available to be utilised in times of stress. This will be done in two main ways:
  - calibrating the framework to include a default level of the countercyclical capital buffer (CCyB) of 100 basis points of risk-weighted assets (RWA) for all ADIs; and
  - for ADIs utilising the internal ratings-based approach (IRB ADIs) to determine their capital requirements, increasing the capital conservation buffer (CCB) from 250 to 400 basis points of RWA (the CCB for ADIs using the standardised approach would remain at 250 basis points);
- implementing more risk-sensitive risk weights, particularly for residential mortgage lending. Given the extent of mortgage lending on Australian bank balance sheets, APRA is proposing a more risk-sensitive approach for determining the capital requirement for mortgage exposures;
- enhancing competition by implementing a floor to limit the capital benefit of IRB ADIs relative to the capital requirement for ADIs utilising the standardised approach, and more generally limiting some of the differences between standardised and IRB capital outcomes;
- improving transparency and comparability by better aligning APRA's standards with the internationally agreed Basel III capital framework, and requiring IRB ADIs to also publish their capital ratios under the standardised approach; and
- applying a proportionate approach for smaller ADIs with less than $20 billion dollars in total assets. For these ADIs, a simplified capital framework will apply that will lessen regulatory burden without compromising prudential safety.

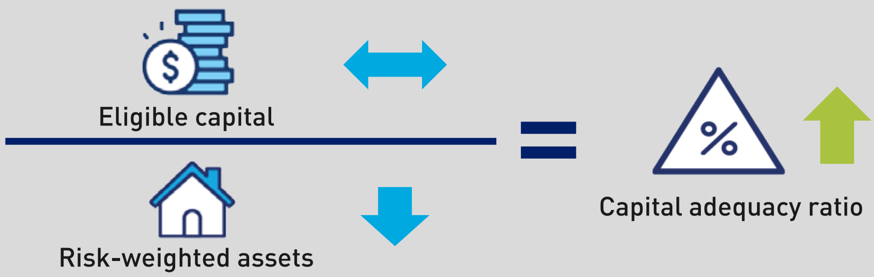
Given the ambitious nature of the capital reforms, and that impacts may differ between different ADIs, there will inevitably be some trade-offs in achieving these outcomes. APRA's proposals aim to strike the appropriate balance between the objectives.

Presentation of capital ratios

With amendments across a number of dimensions, reported capital ratios will inevitably change (Box 1 below summarises how these changes will occur). However, APRA remains committed to its previous position that an ADI that currently meets the 'unquestionably strong' benchmarks under the current framework should have sufficient capital to meet any new requirements. Changing the presentation of capital ratios will not impact overall capital strength or the quantum of capital required to be considered 'unquestionably strong'; but instead improves comparability, supervisory flexibility and international alignment.

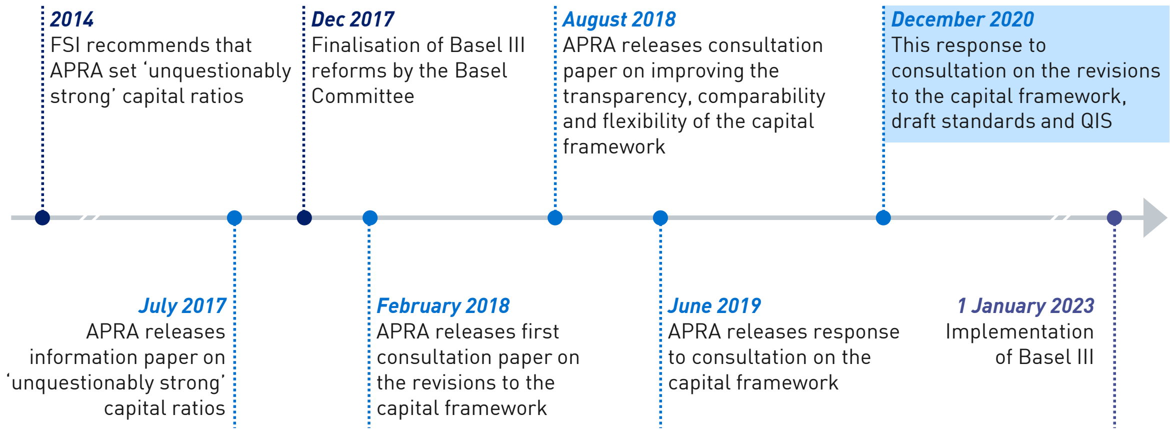
Box 1 – change in measurements and impact on capital ratios

APRA's proposals will change the presentation of capital ratios. This is because the denominator of the capital ratio calculation – RWA – is changing to be more aligned with the international Basel methodology, while the dollar amount of eligible capital required remains unchanged. All else being equal, this will increase capital ratios.



The way forward

This package responds to a number of prior consultations on the ADI capital reforms, including APRA's proposals on improving the transparency, comparability and flexibility of the capital framework and the leverage ratio. Due to the number of consultations APRA is responding to in this package, there are two papers: this paper provides a high-level overview of APRA's proposals and their indicative impacts, and is complemented by the *Response to submissions: A more flexible and resilient capital framework for ADIs* (response paper) that provides a more detailed response to specific technical issues raised in the prior consultations.



APRA is also releasing for consultation full drafts of *Prudential Standard APS 110 Capital Adequacy*, *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* and *Prudential Standard* APS *113 Capital Adequacy: Internal Ratings-Based Approach to Credit Risk*. To support the next phase of the consultation process, APRA will be seeking further data from selected ADIs via a quantitative impact study (QIS) to ensure the final standards are appropriately calibrated. As previously announced, it is proposed that the new framework will come into effect from 1 January 2023.

This current round of the consultation is open until 1 April 2021.

Key highlights

The table below compares the key proposals in this paper with the current capital framework. The proposed framework builds from the previous consultations.

Proposals	Current framework	Proposed framework
Capital framework	Minimum CET1 requirements for standardised ADIs: • PCR: 4.5% • CCB: 2.5% • CCyB: 0% default level Minimum CET1 requirements for IRB ADIs: • PCR: 4.5% • CCB: 2.5% • CCyB: 0% default level • D-SIB: 1.0% (only applies to the four major banks)	Minimum CET1 requirements for standardised ADIs: • PCR: 4.5% • CCB: 2.5% • CCyB: 1.0% default level Minimum CET1 requirements for IRB ADIs: • PCR: 4.5% • CCB: 4.0% • CCyB: 1.0% default level • D-SIB: 1.0% (only applies to the four major banks)
Residential mortgages	Standardised ADIs • Segmentation by 'standard' or 'non-standard' loan, lowest risk weight available is 35% IRB ADIs • For IRB ADIs, a correlation factor adjustment to narrow the difference to the average risk weight under the standardised approach • 20% LGD floor • No recognition of lenders' mortgage insurance in IRB models	Standardised ADIs • Additional segmentation by loan purpose (owner-occupier, paying principal-and-interest, and other), lowest risk weight available is 20% IRB ADIs • Scalars replace correlation factor adjustments, additionally targeting higher risk mortgage segments in line with the standardised approach • 10% LGD floor for approved models • Aligned recognition of LMI in IRB models with standardised approach

Proposals	Current framework	Proposed framework
Lending to SMEs	Standardised ADIs • No recognition of commercial property security • SME lending, not secured by property, 100% risk weight IRB ADIs • Retail SME approach for lending less than $1m in size • Corporate SME approach for annual turnover less than $50m	Standardised ADIs • Risk weights vary by level of commercial property security • SME lending, not secured by property, 75% risk weight if less than $1.5m in size, otherwise 85% risk weight IRB ADIs • Retail SME approach for lending less than $1.5m in size • Corporate SME approach for annual turnover less than $75m
Other credit portfolios	Standardised ADIs • Largely aligned with Basel framework IRB ADIs • Overall scalar to credit RWA of 1.06x • Higher risk estimates compared to overseas peers for the corporate portfolio and limited use of models for commercial property exposures	Standardised ADIs • Largely aligned with Basel framework IRB ADIs • Overall scalar to credit RWA of 1.1x • Reduction in gap to risk estimates relative to overseas peers, models allowed to calculate capital requirements for commercial property exposures
New Zealand	APRA requirements apply, although risk estimates are approved by Reserve Bank of New Zealand (RBNZ)	RWA determined by RBNZ used for group capital requirements
Proportionality in the framework	No threshold for simplified requirements and all ADIs subject to materially similar reporting requirements	Small ADIs (below $20 billion total asset threshold) can benefit from: • Flat operational risk capital charge of 10 per cent of RWA • No counterparty credit risk capital or reporting requirements • Interest rate risk in the banking book requirements limited to reporting only • No leverage ratio capital or reporting requirement • APRA centralised Pillar 3 publication
Comparability	No floor on RWA differences between standardised and IRB approaches	IRB RWA requirements cannot fall below 72.5% of RWA calculated under standardised approaches

Further detail can be found in this paper and the response paper.

Chapter 1 - Objectives

1.1 Background

In February 2018, APRA commenced its consultation on the reform of the ADI capital framework to enhance the financial resilience of the banking system. To date, the consultation process has encompassed three interdependent work streams:

- setting the quantum of capital as detailed in the July 2017 information paper, *Strengthening banking system resilience – establishing unquestionably strong capital ratios*;[1]
- two discussion papers on the allocation and risk sensitivity of capital requirements in February 2018 and June 2019;[2] and
- improving the flexibility of the capital framework and the presentation of capital ratios and minimum requirements as outlined in the August 2018 discussion paper, *Improving the transparency, comparability and flexibility of the ADI capital framework*.[3]

APRA has also consulted on related amendments to the leverage ratio and revisions to the interest rate risk in the banking book (IRRBB) framework.[4,5] APRA finalised prudential requirements for operational risk in December 2019.

This paper sets out APRA's key proposals for the reform of the ADI capital framework. It is accompanied by a response paper that sets out the response to feedback received in prior consultations and more technical detail on the proposed changes to the prudential standards.

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[1] APRA, *Strengthening banking system resilience – establishing unquestionably strong capital ratios* (Information Paper, July 2017) https://www.apra.gov.au/news-and-publications/apra-announces-'unquestionably-strong'-capital-benchmarks.

[2] APRA, *Revisions to the capital framework for authorised deposit-taking institutions* (Discussion Paper, February 2018); APRA, *Revisions to the capital framework for authorised deposit-taking institutions* (Response Paper, June 2019). Both these papers can be found at: https://www.apra.gov.au/consultations-on-revisions-to-capital-framework-for-authorised-deposit-taking-institutions.

[3] APRA, *Improving the transparency, comparability and flexibility of the ADI capital framework* (Discussion Paper, August 2018) https://www.apra.gov.au/consultations-on-revisions-to-capital-framework-for-authorised-deposit-taking-institutions.

[4] APRA, *Leverage ratio requirement for ADIs* (Discussion Paper, February 2018; Response Paper, November 2018; and Letter, November 2019) https://www.apra.gov.au/leverage-ratio-requirement-for-authorised-deposit-taking-institutions.

[5] APRA, *Interest rate risk in the banking book for ADIs* (Response Paper, September 2019) https://www.apra.gov.au/consultations-on-revisions-to-capital-framework-for-authorised-deposit-taking-institutions.

1.1.1 Outline of this paper

This chapter discusses how the reforms meet APRA's objective of enhancing financial system resilience. Chapter 2 provides an overview of the proposed capital framework. Chapter 3 discusses APRA's proposals on the residential mortgage asset class and the subsequent chapters discuss implications for competition and regulatory burden.

1.2 Enhancing financial system resilience

APRA's mandate is to ensure that, under all reasonable circumstances, financial promises made by institutions it supervises are met within a stable, efficient and competitive financial system. Consistent with this mandate and APRA's strategic objective of delivering on the community outcome of maintaining financial system resilience, APRA's revisions to the ADI capital framework aim to deliver a strengthened and more flexible capital framework to enhance resilience and underpin confidence in the banking system.[6]

A strong and robust capital framework for ADIs supports the capacity of the system to adjust to both the ordinary business cycle and severe economic shocks, while continuing to provide core economic functions. The table below sets out APRA's objectives in reforming the capital framework to enhance financial system resilience and to achieve other beneficial improvements.

APRA's key objectives for the reform of the ADI capital framework:
Unquestionably strong: strengthen the capital framework to incorporate 'unquestionably strong' capital benchmarks
Basel III: adherence with the internationally agreed Basel III framework
Other key improvements:
Flexibility: increase APRA's ability to adjust capital requirements in response to the economic and credit environment
Risk sensitivity: make the capital framework more risk-sensitive, with more capital held for higher risks. Increase the capital allocated to higher risk mortgage segments to reflect the structural concentration of the Australian financial system to **residential mortgage lending**.
Competition: enhance competition by limiting the difference in capital outcomes between ADIs using the internal ratings-based (IRB) and standardised approaches
Transparency and **comparability:** improve the transparency of the ADI capital framework to better enable comparisons of capital adequacy across ADIs and international peers
Proportionality: enhance proportionality in the framework and apply simplicity to lessen regulatory burden, in particular for smaller ADIs, without compromising prudential safety

In achieving these objectives, APRA aims to deliver a strengthened and more flexible capital framework that is in line with international standards.

[6] APRA, *Corporate Plan 2020-2024*, (August 2020). https://www.apra.gov.au/news-and-publications/apra-2020-2024-corporate-plan.

1.3 Key objectives of the reforms

1.3.1 Achieving 'unquestionably strong' capital benchmarks

Historically Australia has had a strong and stable financial system with a resilient and well capitalised banking system. The 2014 Financial Sector Inquiry (FSI) recognised that while the banking system was generally well capitalised, a strengthening of capital requirements to be 'unquestionably strong' could enhance financial system resilience and maintain confidence.

The July 2017 information paper *Strengthening banking system resilience – establishing unquestionably strong capital ratios* set out the average target level of capital APRA is seeking to achieve through the capital reforms. This would be an increase in minimum capital requirements equivalent to 150 basis points for IRB ADIs and 50 basis points for standardised ADIs, based on the methodology and capital levels at the time. This was intended to be an average industry outcome, with the impact on individual ADIs likely to vary based on portfolio composition and risk profile.

The proposals in this paper seek to formalise the 'unquestionably strong' capital benchmarks into the ADI capital framework. As the reforms to the ADI capital framework will alter the measurement of RWA, ADI capital ratios will also differ from their current presentation. Importantly however, this will not change the dollar value of capital required under 'unquestionably strong' capital benchmarks.

1.3.2 Adherence with Basel III

The Basel III framework, set out by the Basel Committee on Banking Supervision, is the internationally agreed minimum capital framework for internationally active banks.[7] APRA has used the Basel III framework as a starting point for developing its proposals and has aimed to ensure that its regulatory capital requirements are at least equivalent to the minimum requirements set out in the Basel III framework. The Basel III framework allows jurisdictions to exercise national discretion for local conditions and circumstances. APRA has a long-standing approach of requiring ADIs to hold additional capital beyond internationally agreed minimum requirements in response to risks relevant to the Australian market. In exercising this judgement, APRA aims to apply amendments that are consistent with the other objectives of the reforms, including that the framework is more transparent and comparable for elements where APRA has set requirements above international minimums.

1.4 Other key improvements from a strengthened, flexible and internationally aligned capital framework

1.4.1 Increasing the flexibility of the capital framework

A more flexible capital framework is one that can respond appropriately to the prevailing environment. In a time of stress, for example, this means that the capital framework can act countercyclically and better support the ability of the financial system to absorb losses and

[7] Australia is a member of the Basel Committee on Banking Supervision, which is the international standards setting body for the prudential regulation of banks.

continue lending to credit-worthy borrowers. To provide APRA with more flexible tools to adjust regulatory capital levels, APRA will increase the size of regulatory buffers relative to the minimum capital requirement and the distance to the point of regulatory intervention included within capital instruments.

In particular, as foreshadowed in the August 2018 discussion paper, *Improving the transparency, comparability and flexibility of the ADI capital framework*, APRA intends to calibrate the framework to include a default level of the countercyclical capital buffer (CCyB) of 100 basis points of RWA for all ADIs.[8] The CCyB allows APRA to vary the buffer requirement in response to the economic cycle. A non-zero default level will enable APRA to lower requirements below this level in times of system-wide stress, providing additional flexibility to the system and supporting the ability of ADIs to continue to lend during times of stress.

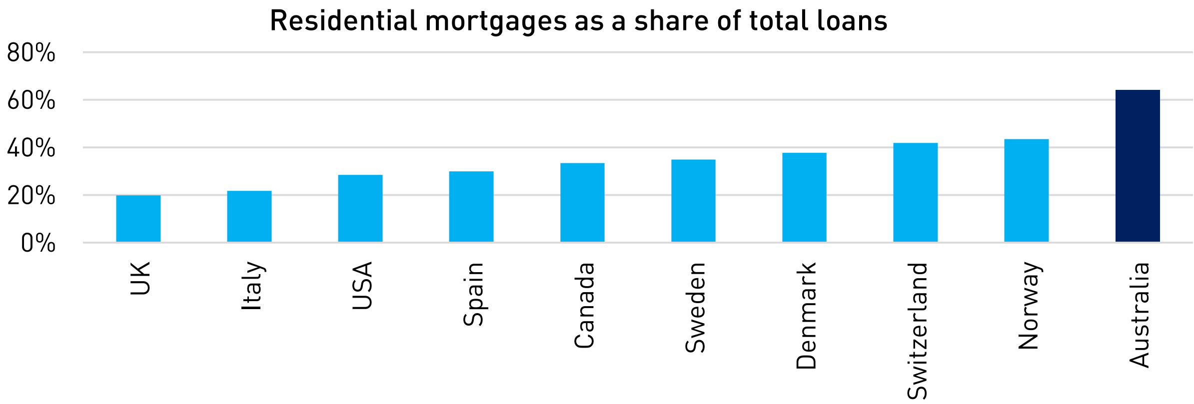
1.4.2 Ensuring appropriate risk sensitivity

APRA's capital framework for ADIs is risk-based and is intended to allocate more capital to sources of higher risk.

Reflecting structural concentration in residential mortgages

For residential mortgage exposures, APRA has had a long-standing intention to strengthen capital requirements to reflect risks posed by Australian ADIs' structural concentration. While an individual residential mortgage loan does not, on its own, pose a systemic risk to the financial system, the accumulation of lending by almost all ADIs in this asset class means that in aggregate, the system is exposed to heightened risks. In this sense, Australia is not unique. For many jurisdictions, lending for residential mortgages comprises a significant component of bank balance sheets, as shown by Figure 1 below, although Australian exposures are notably higher.

Figure 1. Comparison of the share of residential mortgages on bank balance sheets



Source: IMF Financial Soundness Indicators. Australian data as at June 2019.

[8] The CCyB, introduced as part of the 2013 Basel III reforms, is a component of the capital framework intended to increase the resilience of the ADI sector during periods of heightened risk. It also provides for international reciprocity of the level of the buffer to ensure a level playing field between foreign and domestic banks.

There are a broad range of factors beyond regulatory capital requirements that have influenced the build-up of residential mortgage lending as a share of total lending. However, for the purposes of the current reforms, APRA's objective is to strengthen the amount of capital held by ADIs for residential mortgage lending to enhance financial system resilience and underpin confidence that there is sufficient capital allocated to this important and material asset class. While the housing portfolio has so far remained resilient in the current economic downturn, the concentration in residential mortgage lending remains a systemic vulnerability, particularly if more severe economic risks eventuate, such as a period of higher unemployment. In strengthening capital requirements for residential mortgages, APRA is particularly targeting higher risk segments such as investor lending and loans with a lengthy interest-only period. This approach should also support sustainable lending in this portfolio in the longer term.

Reduced risk weights for SME lending

APRA will also adjust the capital treatment of lending to small- and medium-sized enterprises (SME) to achieve better risk sensitivity in this asset class. APRA is proposing lower risk weights under the standardised approach for SME lending not secured by residential property and broadening the definition of loans eligible for lower risk weights under the IRB approach. These proposals are aligned with the Basel III framework and will provide some additional incentive for ADIs to lend to small businesses relative to other forms of lending.

1.4.3 Enhancing competition between standardised and IRB ADIs

APRA's proposals are designed to establish a sound policy framework for bank capital that, while meeting financial stability and resilience objectives, also enable effective competition. Capital requirements provide an incentive for ADIs to price and manage risk effectively. APRA considers it important that capital incentives remain for ADIs to seek and maintain IRB accreditation as the IRB approach facilitates improved risk reporting and portfolio risk management, which promotes financial resilience. APRA acknowledges, however, that these incentives should not be unlimited and that the regulatory framework may have an unintended impact on competition in the financial system.

The introduction of the capital floor limits the regulatory capital benefits of the IRB approach compared to the standardised approach. APRA's reforms will also reduce the differences in capital outcomes between the standardised and IRB approaches compared to the current framework, such as for SME and commercial property lending. In 2015, APRA reduced the gap between standardised and IRB capital outcomes for the residential mortgage portfolio, and as part of the current reforms, is intending that this gap, at an average portfolio level, does not widen. IRB ADIs will also have higher regulatory buffer requirements compared to standardised ADIs.

1.4.4 Improving transparency and comparability

As larger ADIs seek funding from international investors and also operate in international markets, it is important that the capital framework is comparable to those used by international peers and that adjustments APRA has made to the minimum Basel framework are transparent to stakeholders. APRA intends to align the ADI capital framework more closely with the Basel framework to facilitate improved transparency and comparability. The requirement for IRB ADIs to also disclose their regulatory capital ratios under the standardised approach will also support domestic comparisons between ADIs under the standardised and IRB approaches.

APRA intends to continue its long-standing approach of setting capital requirements appropriate to Australian circumstances. Where there are adjustments to the Basel framework, APRA has sought to implement these in a simpler and more transparent manner that can be better understood by stakeholders. This should improve the transparency and comparability of the framework.

1.4.5 Proportionality

APRA intends to apply a proportionate approach to implementing capital requirements where it does not jeopardise financial safety or financial system resilience. For all ADIs, compliance with prudential requirements is a necessary cost of operation, given their role in holding deposits for the Australian community. For smaller ADIs, regulatory costs are usually a larger portion of their cost base. Some components of the proposals will introduce additional complexity relative to the current framework, but are intended to deliver enhanced financial system resilience. APRA judges that applying the capital framework in a proportionate manner to ADIs that fall under certain thresholds would substantially reduce their compliance and reporting burden, with limited risk to financial safety.

In considering regulatory burden, APRA has considered where it can reduce undue compliance and reporting costs for ADIs and, in particular, for smaller ADIs. This has been balanced against recognising the benefits to the system and the community of having a robust capital framework that supports effective and timely prudential regulation, including access to appropriate data.

Chapter 2 - Overview of the capital framework

This chapter summarises the key changes to the capital framework. These proposals build on prior consultations and stakeholder feedback. APRA aims to calibrate the revised capital framework consistent with the 'unquestionably strong' capital objective and align the framework with the internationally agreed Basel III framework. APRA also intends to implement larger regulatory buffers to improve the flexibility of the framework in responding to situations of heightened risk or stress.

2.1 Features of the proposed framework

2.1.1 Quantum of capital required to be 'unquestionably strong'

This response package does not propose any additional increase to overall capital requirements but instead formalises the strengthening of capital requirements as previously determined under APRA's 'unquestionably strong' capital benchmarks.

Consistent with these benchmarks, APRA has targeted an increase in minimum capital requirements of 50 basis points, on average, for standardised ADIs; and an increase of 150 basis points, on average, for IRB ADIs. This sets the target level of capital requirements for the proposed capital reforms. Australian ADIs already hold capital sufficient to meet these targets.

APRA's proposed approach will result in changes to the calculation of RWA and will, therefore, result in changes to presented capital ratios. All else being equal, under the proposed methodology, ADI capital ratios will appear higher than ratios calculated under the current methodology. Given these changes in measurement, APRA is targeting a capital outcome in dollar terms that remains consistent with the strengthening of capital set out by the 'unquestionably strong' capital benchmarks.

Importantly, APRA's proposals to change the basis of measurement of capital adequacy will improve comparability, supervisory flexibility and international alignment. Section 2.2 below sets out an illustrative example of the proposed changes and details the expected alignment with 'unquestionably strong' capital benchmarks.

2.1.2 Building greater flexibility into the capital framework

A more flexible capital framework is one that can better respond to the prevailing risk environment. This can mean requiring ADIs to build up buffers in times of heightened risk and allowing ADIs to use those capital buffers in times of stress to absorb losses and support lending. APRA's proposals seek to increase the flexibility of the capital framework by increasing the size of regulatory buffers relative to minimum prudential capital requirements (PCR). APRA is not adding new buffers into the prudential framework but instead is building on existing tools.

Countercyclical capital buffer

APRA proposes to calibrate the framework to include a default level of the countercyclical capital buffer (CCyB), set at 100 basis points of RWA, to apply to all ADIs. The CCyB is operationalised as an extension of the capital conservation buffer (CCB).

Since its introduction, the level of the CCyB has remained unchanged at a default level of zero per cent of RWA. However, APRA recognises that having a buffer built up in benign economic times for the purpose of being released in times of system-wide stress is likely to be valuable. Such a buffer could provide additional flexibility to the system and dampen the impact of regulatory capital requirements on the supply of credit during stress.

The prevailing level of the CCyB may not be set at the new default level at the time of implementation (planned for 1 January 2023), and will depend on APRA's judgement of the economic conditions and the level of systemic risk at the time. APRA will also revise the indicator framework that sets out the operation of the CCyB, including articulating APRA's expectation for when the CCyB would move upwards or downwards from its default position.

Expanding the capital conservation buffer for IRB ADIs

APRA is proposing to implement further flexibility in the capital framework for IRB ADIs relative to standardised ADIs to reflect the greater level of risk sensitivity inherent in the IRB approach. APRA proposes an additional 1.5 per cent buffer for all IRB ADIs, to be met as an expansion of the CCB. The table below sets out the different levels of the CCB that would apply to standardised and IRB ADIs, including those IRB ADIs that are also domestic systemically important banks (D-SIBs).

Table 1. The proposed calibration of the capital conservation buffer

% of RWA	Current CCB	Proposed CCB, assuming a 100 basis points default CCyB
D-SIB ADIs	3.5%	6.0%
Other IRB ADIs	2.5%	5.0%
Standardised ADIs	2.5%	3.5%

An increased CCB for IRB ADIs allows APRA to fulfil a number of its objectives in enhancing financial system resilience. The expanded CCB allows APRA to meet the 'unquestionably strong' calibration for IRB ADIs while making the capital framework more flexible to respond to situations of heightened risk or stress. It also allows APRA to align the calculation of RWA closer to the Basel framework while still preserving strengthened capital requirements where APRA has adjusted international minimum requirements.

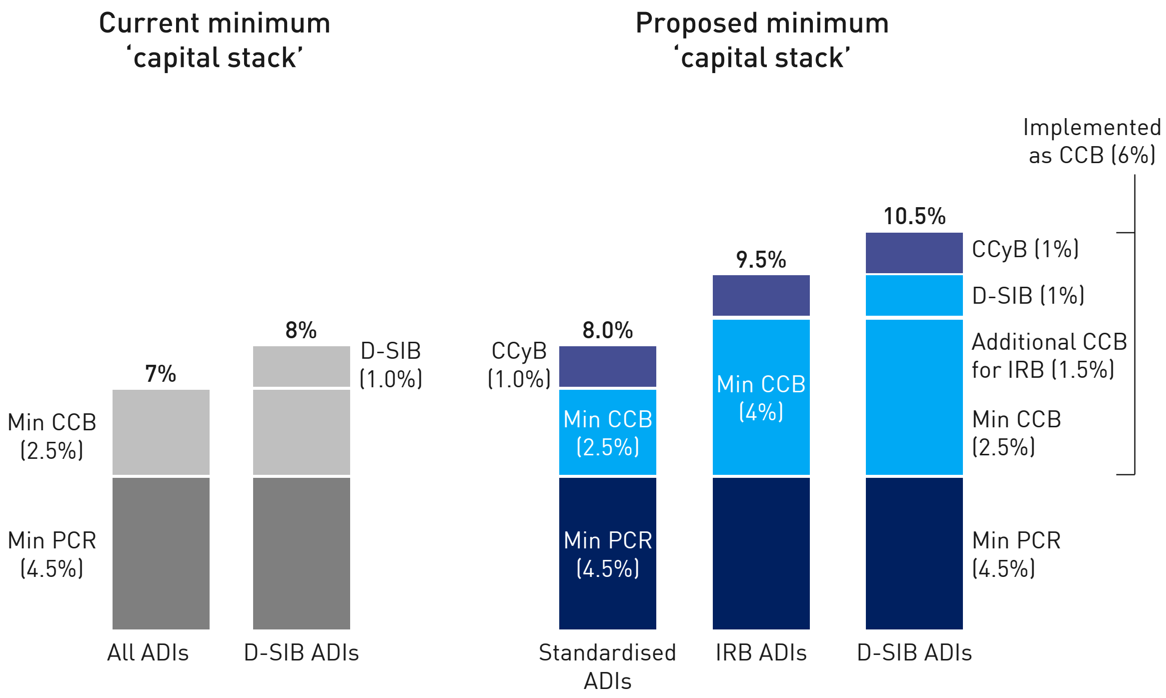
2.1.3 The proposed Common Equity Tier 1 capital 'stack'

The net outcome of the proposals detailed in this section result in the minimum capital stack for Common Equity Tier 1 (CET1) capital shown in Figure 2 below. For clarity, it assumes the CCyB is set at its default level of 100 basis points of RWA. Under the proposed framework, a greater proportion of regulatory requirements are to be held as buffers with no change to the minimum PCR requirement. The total minimum CET1 PCR and CCB ratio requirements will increase from:

- 7 per cent of RWA for standardised ADIs to 8 per cent;
- 7 per cent of RWA for IRB ADIs to 9.5 per cent; and
- 8 per cent of RWA for D-SIB ADIs to 10.5 per cent.

Section 2.2 below sets out how the capital ratio requirements above can be reconciled with the changes to the calculation of RWA.

Figure 2. Changes to the CET1 'capital stack'



The CCyB is currently set at 0% of RWA. APRA is calibrating the proposed framework to a non-zero default CCyB of 1% of RWA – actual CCyB at the time of implementation may be different.
All regulatory buffers are operationalised as an extension of the CCB.
The 4 major banks (ANZ, CBA, NAB, WBC) are designated D-SIBs and are also IRB ADIs.

2.1.4 The capital floor for IRB ADIs

APRA intends to implement the Basel III capital floor that limits the capital benefit available to IRB ADIs to no more than 72.5 per cent of the RWA outcome available under the standardised approach. The capital floor is a risk-based backstop that is intended to support the credibility of ADIs' RWA calculations and improve comparability between the standardised and IRB approaches by requiring IRB ADIs to disclose their capital outcomes on the standardised approach. APRA signalled its intention to implement the capital floor in both the February 2018 and June 2019 discussion papers.

APRA proposes to implement the floor in line with the Basel proposals, but with the addition of regulatory capital held for interest rate risk in the banking book (IRRBB) consistent with APRA's requirement that this is part of an IRB ADI's minimum capital requirement. Figure 3 below represents APRA's proposed implementation of the capital floor for IRB ADIs.

Figure 3. Components of the capital floor

IRB approach to credit risk includes the proposed 1.1 IRB scaling factor.
There are certain asset classes or risk types that have common approaches for both IRB and standardised ADIs, such as operational risk.
CVA: credit valuation adjustment.

2.1.5 Implications for other tiers of capital

This paper focuses on the impact of APRA's proposals on the CET1 ratio requirement. This is intentional as CET1 capital is the highest quality form of regulatory capital and it is also the tier of capital that ADIs must hold to meet regulatory buffers and 'unquestionably strong' capital targets. Other forms of capital are, however, also available to absorb losses and support financial system resilience. APRA does not propose any changes to the minimum ratio requirements for Tier 1 Capital or Total Capital; set at 6 per cent and 8 per cent of RWA respectively.

For certain ADIs, APRA has also set an additional amount of capital to be held as loss absorbing capacity (LAC) to support orderly resolution. APRA will evaluate any consequential adjustment to the amount of required LAC for those ADIs in line with the review of the long-term LAC targets, taking into account the changes to the framework arising from these proposals.[9]

The proposals in this paper are expected to reduce total RWA, meaning that, all else being equal, the quantum of minimum capital required at each tier of capital will be reduced compared to the current framework. This remains appropriate as APRA seeks to increase the flexibility of the capital framework by allocating more capital into regulatory buffers rather than regulatory minimums and that minimum requirements are more aligned with the international Basel framework. Importantly, CET1 capital strength remains unchanged as the

[9] https://www.apra.gov.au/news-and-publications/apra-responds-to-submissions-on-plans-to-boost-loss-absorbing-capacity-of

sum of the regulatory minimum (PCR) and buffer requirements are intended to be calibrated at a level consistent with 'unquestionably strong' capital benchmarks.

2.2 Reconciling strengthened capital requirements with RWA changes

A note on data

The data presented in this paper was collected as part of the quantitative impact study (QIS) accompanying the June 2019 response paper and other data available to APRA. There were six IRB ADIs and 21 standardised ADIs that provided data. The quantitative outcomes set out in this paper should be interpreted as directional estimates requiring further review as the consultation progresses, including to account for any potential cyclical impacts in more recent data.

APRA's proposals impact the presentation of capital adequacy ratios in various ways:

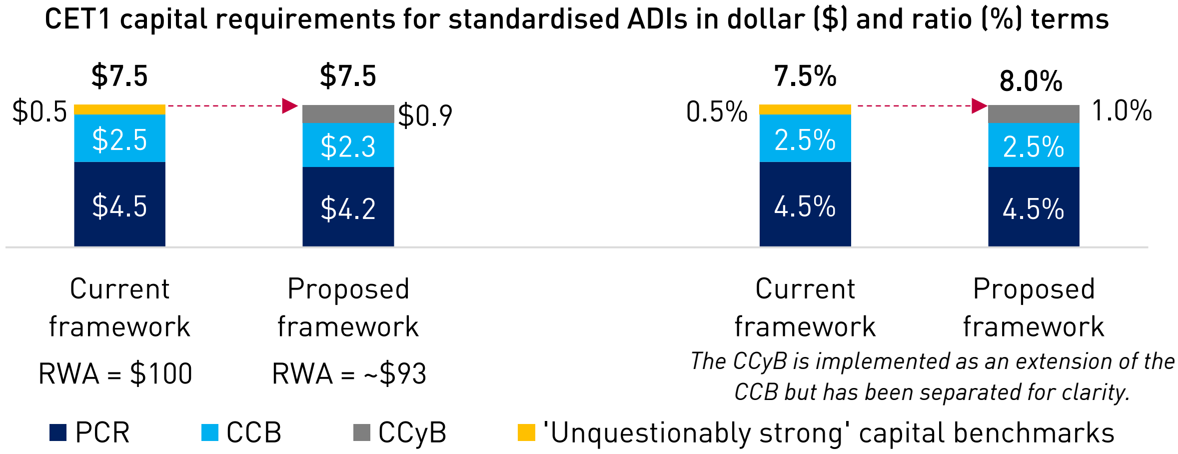
- the quantum of capital targeted by the calibration of the long-term framework is increased to formalise the 'unquestionably strong' capital benchmarks;
- the amount of RWA will likely fall as APRA will more closely align minimum requirements to the internationally agreed Basel III framework. APRA has estimated an RWA decrease of 10 per cent on average for IRB ADIs and 7 per cent on average for standardised ADIs; and
- APRA is enhancing the flexibility of the framework by allocating more capital to regulatory buffers (the CCB, inclusive of the CCyB). All else being equal, capital allocated to minimum PCR will likely fall compared to the current framework. This is offset by the increased allocation to regulatory buffers.

Given ADIs are currently meeting APRA's 'unquestionably strong' benchmarks, it is not APRA's intent to require ADIs to raise additional capital. APRA has therefore sought to calibrate the proposed capital requirements, measured in dollar terms, to be consistent at an industry level with the 'unquestionably strong' capital benchmarks under the current framework.

The impact of these changes on individual ADIs will vary depending on their 'unquestionably strong' capital benchmark (whether the ADI utilises the IRB or standardised approach), risk profile, any additional supervisory adjustments (Pillar 2) to minimum capital requirements, and the level of management surplus above regulatory requirements. For an IRB ADI currently at a 10.5 per cent CET1 capital ratio, APRA expects that the presentation of the capital ratio, assuming no change in risk profile, would increase to between 11.5 to 12 per cent under these proposals.

To reconcile this change in the presentation of the capital ratio with the 'unquestionably strong' capital benchmarks, Figures 4 and 5 below set out indicative examples of the impact for standardised ADIs and IRB ADIs that are also D-SIBs. In the examples below, ADIs are assumed to have RWA of $100 under the current framework and capital sufficient to meet their 'unquestionably strong' capital benchmarks prior to the implementation of the proposed capital framework.

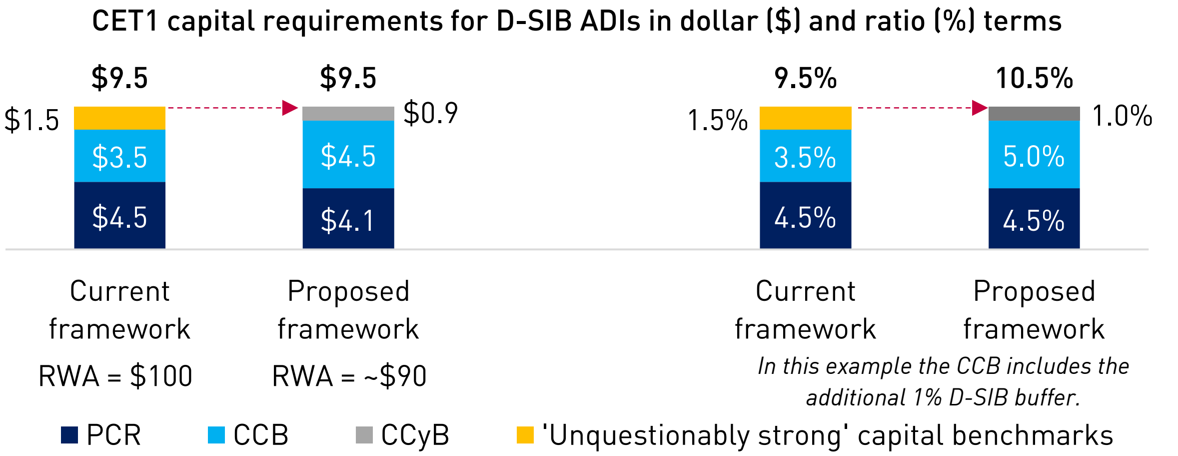
Figure 4. Changes to capital ratio requirements for standardised ADIs



The 'unquestionably strong' capital benchmarks raised capital requirements for standardised ADIs by 50 basis points, on average, which is equivalent to $0.5 in the example in Figure 4 above. Under the current framework this is being held by ADIs as surplus above regulatory minimum and buffer requirements (PCR and CCB). APRA's proposals will better align the calculation of RWA with the international Basel III framework. This will reduce the required total RWA, in this example from $100 to $93, which changes the capital ratio but not the dollar amount of capital required to meet regulatory minimum and buffer requirements ($7.5 in this example).

Under APRA's proposals, the strengthening of capital from 'unquestionably strong' capital benchmarks are now formalised into regulatory minimum and buffer requirements, which incorporates a 100 basis points default level of the CCyB. The net result is that capital levels are strengthened to now incorporate the 'unquestionably strong' capital benchmarks and capital ratios are more internationally comparable, and higher than under the current methodology.

Figure 5. Changes to capital ratio requirements for D-SIB ADIs



IRB ADIs have an 'unquestionably strong' capital benchmark of 150 basis points above their minimum capital requirements, or $1.5 in the example in Figure 5 above. APRA estimates that total RWA would fall for IRB ADIs under the revised framework by approximately 10 per cent on average; in the example in Figure 5, from $100 to $90. For D-SIB ADIs, the starting point is inclusive of the add-on to the CCB for a D-SIB (set at 1 per cent of RWA).

Changing the presentation of capital ratios will not impact overall capital strength. Importantly, for all ADIs, the long-term capital framework will be calibrated to a level that strengthens financial system resilience consistent with 'unquestionably strong' capital benchmarks, while increasing flexibility and having a more internationally aligned framework.

Chapter 3 - Residential mortgages

Residential mortgage lending is the largest credit portfolio, individually for many ADIs, and for the financial system in aggregate. Borrowers, in the main, have weathered the pandemic in a sound position, supported by fiscal, monetary and industry responses. However, structural factors remain that mean residential mortgage lending will continue to be a source of systemic vulnerability for the Australian financial system, particularly if severe economic risks eventuate. APRA's proposals seek to ensure that the financial system is resilient to these risks and can respond flexibly to situations of stress. APRA's proposals build on feedback received from prior consultations and are summarised below.

3.1 Strengthening capital for residential mortgages

A key objective for APRA is to further strengthen capital requirements for residential mortgage exposures to reflect risks posed by Australian ADIs' structural concentration in this asset class. APRA is strengthening requirements in two main ways:

- increasing the capital allocated to housing as a proportion of credit RWA. For standardised ADIs this increases from 52 per cent to 54 per cent and for IRB ADIs from 34 per cent to 40 per cent. A key driver of this proportional increase is reductions in the capital requirements relating to SME, corporate and commercial property lending; and
- adjusting the risk segmentation to target key risks such as investment and interest-only lending. This segmentation is detailed further below.

3.1.1 Targeting key risks for residential mortgages

As proposed in previous consultations, in strengthening capital requirements for residential mortgage exposures, APRA is targeting higher capital requirements for investor and interest-only lending. This approach is consistent with APRA's supervisory interventions in recent years and will result in lower capital requirements for owner-occupied principal-and-interest exposures, which are generally considered to be of comparatively lower risk. In this consultation, APRA is additionally proposing:

- that lending with an interest-only period greater than five years would no longer be eligible to be included as a standard loan to reflect the heightened risk when principal is not paid down over a long period;
- that under the standardised approach, to split the 60 to 80 per cent loan-to-valuation ratio (LVR) category into two segments (60 to 70 LVR and 70 to 80 LVR) to reflect different levels of risk and to smooth out the capital outcomes for the large amount of exposures in this segment; and
- to align the credit conversion factor for undrawn exposures under the standardised approach with the 40 per cent estimate in the Basel framework.

Table 2 sets out the proposed risk segmentation and indicative risk weights for residential mortgage exposures under the standardised approach. See section 4.3 in the response paper for additional information.

Table 2. Indicative risk weights under the standardised approach

<table>
<tr><th colspan="2" rowspan="2">Standard loan LVR %</th><th colspan="7">RW %</th></tr>
<tr><th>≤ 50</th><th>≤ 60</th><th>≤ 70</th><th>≤ 80</th><th>≤ 90</th><th>≤ 100</th><th>> 100</th></tr>
<tr><td rowspan="2">Owner-occupied principal-and-interest mortgages</td><td>LMI</td><td rowspan="2">20</td><td rowspan="2">25</td><td rowspan="2">30</td><td rowspan="2">35</td><td>40</td><td>55</td><td>70</td></tr>
<tr><td>No LMI</td><td>50</td><td>70</td><td>85</td></tr>
<tr><td rowspan="2">Other residential mortgages</td><td>LMI</td><td rowspan="2">25</td><td rowspan="2">30</td><td rowspan="2">40</td><td rowspan="2">45</td><td>50</td><td>70</td><td>85</td></tr>
<tr><td>No LMI</td><td>65</td><td>85</td><td>105</td></tr>
</table>

Under the IRB approach, APRA intends to proceed with its proposal to base regulatory capital requirements on the Basel risk-weight function for residential mortgages and apply two multipliers based on the same segmentation as the standardised approach. Table 3 details the indicative multipliers for each segment.

Table 3. Indicative multipliers under the IRB approach

Owner-occupied, principal-and-interest mortgages	1.4 x
Other residential mortgages	1.6 x

3.2 Lenders' mortgage insurance

Lenders' mortgage insurance (LMI) is an insurance policy taken out by an ADI to protect the ADI from the risk of financial losses on mortgage lending. In most cases, while the policy covers the ADI, it is paid for by borrowers. General market practice has been for ADIs to require borrowers seeking to borrow more than 80 per cent of the value of the property securing the loan to take out LMI cover.

APRA has long recognised the risk transfer benefits of LMI. The availability of LMI to the banking system provides an additional degree of risk diversification and portfolio risk management. Under the standardised approach, high LVR loans with LMI cover receive a lower risk weight than if the loan did not have LMI cover. APRA will continue to recognise LMI in the standardised approach to credit risk and, for the first time, will recognise LMI under the IRB approach. This will have the effect of broadening the recognition of LMI in the ADI capital framework across the entire banking industry.

While the standardised approach directly recognises LMI, this recognition has not been available in the IRB framework due to the 20 per cent loss given default (LGD) floor for determining capital requirements for residential mortgage exposures. In line with APRA proposing to lower the LGD floor for ADIs with approved models, APRA has consulted on the recognition of LMI under the IRB approach. The proposed standardised approach provides an approximate 20 per cent discount to the risk weight for high LVR loans with LMI. APRA is proposing to align the level of recognition of LMI under both approaches.

APRA notes that some stakeholders have advocated that the recognition of LMI in both the standardised and IRB approaches should be significantly increased, and that the capital framework should account for differences in product features of LMI. APRA has engaged extensively with these stakeholders and is of the view that the 20 per cent discount on risk-weight outcomes is appropriate and recognises the benefits of LMI as a credible risk mitigant to the banking system. APRA's considerations include that:

- ADIs hold capital directly to absorb losses in their lending portfolios and a fundamental principle of APRA's capital framework for ADIs is that capital must be freely available to absorb losses. In this regard, LMI is an insurance product; it is not a guarantee. Protection provided by LMI is indirectly available to the banking system as it is subject to a claims process that may be uncertain, lengthy or rejected, and so is not a perfect substitute for capital held directly by an ADI. Moreover, capital held by an LMI provider is not fungible in the same way as capital held directly by the ADI.

- In setting this discount on risk-weight outcomes, APRA has had regard to the risk mitigation benefits of LMI in general rather than setting a bespoke treatment for the variety of LMI product differences that could potentially exist in the marketplace. This is consistent with a principles-based regime and APRA will reassess the capital treatment of LMI if the nature or features of the product offered to ADIs changes.

- The proposed discount on risk-weight outcomes recognises the different levels of capital strength between ADIs and LMI providers, as evidenced by their external credit ratings. For the largest ADIs, it would be imprudent to encourage them to build a significant reliance on a lower-rated counterparty.

- LMI recovery claims have the potential to become a material concentration risk in periods of stress. Unlike other concentrated exposures, ADIs are not subject to limits for their large exposures to LMI providers. Instead, APRA has addressed this concentration risk as part of the level of capital recognition of LMI in mortgage risk-weight outcomes.

In APRA's view, the proposed level of recognition of LMI in the ADI capital framework, and expanding this recognition consistently to all ADIs, is appropriate. Further recognition of LMI would dampen the loss absorbing capacity of the financial system for risks in the residential mortgage market and is contrary to APRA's primary objective of calibrating the ADI capital framework to an 'unquestionably strong' level.

Chapter 4 - Competition

APRA's capital framework is proportional and risk-sensitive; capital and risk management expectations increase as a regulated institution's size, complexity and interconnectedness to the financial system increases. APRA is mindful of the influence that the capital framework may have on competitive dynamics, although it is not the sole driver of competitive and business outcomes. APRA's proposals include a number of features that may enhance competitive outcomes between standardised and IRB ADIs:

- implementing additional constraints on the IRB approach, including a capital floor for IRB ADIs to limit the overall difference in RWA between the standardised and IRB approaches;
- expanding regulatory buffer requirements for IRB ADIs more than standardised ADIs, which contributes to formalising the different 'unquestionably strong' capital benchmarks that exist for standardised and IRB ADIs; and
- for residential mortgages, ensuring the average pricing differential that could be reasonably attributed to differences in capital requirements between the standardised and IRB approaches does not widen, while also improving the consistency of capital outcomes at a more granular level. In particular, APRA is increasing the granularity for lower risk weights under the standardised approach and proposing a 5 per cent risk-weight floor for residential mortgages under the IRB approach.

More broadly, APRA's reforms to enhance the resilience of the financial system will help drive stronger and sustainable competition as resilient ADIs make robust competitors.

4.1 Differences between the standardised and IRB approaches

While limiting the difference between the two approaches, APRA continues to consider it appropriate to include a capital incentive for ADIs to invest in the IRB approach. The ongoing benefits for risk sensitivity for ADIs using the IRB approach support a more efficient allocation of capital to risk. Given the different approaches to determining capital requirements between the standardised and IRB approaches, it is simply not possible, or appropriate, that the two approaches deliver an identical outcome in all circumstances.

There are a number of important differences between the standardised and IRB approaches:

- The standardised approach provides simple benchmarks for the majority of ADIs with less complex business models to achieve an appropriate aggregate level of capital. These benchmarks are generally set conservatively, given the need to apply to a wide range of ADIs, including many ADIs that have greater business, strategic or concentration risks.
- The IRB approach recognises that large and diversified ADIs have the capacity to invest in, and maintain, sophisticated risk measurement and management systems and capabilities, allowing regulatory capital to be determined in a more granular and risk-

sensitive manner. As a result, IRB capital requirements are more aligned to the risks of a particular ADI. While IRB capital requirements can, on average, be lower than capital requirements calculated under the standardised approach, capital requirements can also be higher depending upon an ADI's risk profile.

- IRB ADIs are also subject to additional capital requirements that do not apply to standardised ADIs such as capital requirements for IRRBB and the requirement for an expected loss adjustment for exposures modelled under the IRB approach.

- The IRB approach requires significant and ongoing investment in risk measurement and modelling systems and controls. Lower capital requirements recognise the cost in achieving an improved ability to identify and manage risk under the IRB approach. APRA has previously introduced a 'staged' accreditation process to assist standardised ADIs in obtaining IRB status.

4.2 Residential mortgages

The June 2019 response paper set out a stylised example of the impact of capital requirements on the average pricing differential for residential mortgage exposures between the standardised and IRB approaches. In this analysis, APRA concluded that the average pricing differential that could be reasonably attributed to differences in capital requirements was in the order of 5 basis points. APRA has extended that analysis for the updated proposals in this paper and does not expect this differential at the average portfolio level to widen due to the proposed changes to capital requirements. In fact, for certain lower risk segments of the portfolio, the differential in capital and pricing outcomes between standardised and IRB ADIs are expected to narrow. APRA will consider these results further as more data is collected through the QIS.

Box 2 - Differences in capital requirements not captured by risk weights

Commentary on the impact of capital requirements on competition in residential mortgage lending has tended to focus on a simple comparison of risk weights between the standardised and IRB approaches. It is important to note that simple risk weight comparisons are misleading, as there are a number of differences in the way capital requirements are determined under the standardised and IRB approaches. Some key differences between the standardised and IRB approaches in APRA's proposed framework are:

- differences in the minimum regulatory capital buffers applied to standardised and IRB ADIs – in particular, IRB ADIs will be required to hold a larger CCB;
- the IRB mortgage risk-weight function includes a scalar of either 1.4 times or 1.6 times applied to risk-weight outcomes;
- differences in the treatment of credit conversion factors (CCFs) for off-balance sheet amounts under the standardised and IRB approaches – for the same mortgage, this would result in a larger exposure amount to be recognised under the IRB approach;
- the application of capital requirements for IRRBB to IRB, but not standardised, ADIs; and
- the requirement for an expected loss adjustment for IRB, but not standardised, ADIs.

In addition, there are greater operational costs arising from investing in, developing and maintaining risk management systems to support IRB status, as well as data requirements.

The impact of these differences will mean that the actual differences in capital outcomes, and accordingly, competition impacts, between standardised and IRB ADIs will be much narrower than the difference implied by a simple comparison of risk weights for residential mortgage exposures.

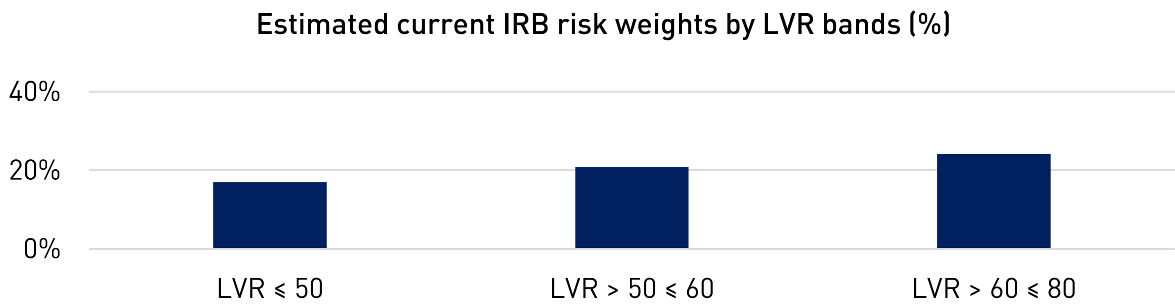
4.2.1 Comparison for low LVR mortgages

A specific concern raised by standardised ADIs in prior rounds of consultation has been the difference in capital requirements for lending at low LVRs. Stakeholders have noted that the lowest risk weight under the standardised approach would be 20 per cent under the proposed framework, but this appears to be significantly lower for the IRB approach. In response to this feedback, APRA has undertaken further analysis at a more detailed level, noting the difference in capital requirements that need to be taken into account when comparing capital outcomes under the standardised and IRB approaches (see Box 2 above).

APRA does not consider that there is a material capital difference between the standardised and IRB approaches at the lower LVR level. For loans with an LVR less than 60 per cent, APRA has estimated that the pricing differential that could be reasonably attributed to differences in the capital requirements between the two approaches would be lower than the differential at the average portfolio outcome.

In understanding the reasons for this outcome, it is important to understand the differences in how the standardised and IRB approaches operate. In particular, there are misconceptions around the capital requirement that would apply to low LVR lending under the IRB approach. For example, it would not be appropriate to solely equate the lowest risk weight reported by IRB ADIs in market disclosures with low LVR loans. The IRB approach considers a more complex range of variable interactions compared to the standardised approach. Under the standardised approach, a low risk weight is assigned to a loan with a low LVR at origination. Figure 6 below shows the actual risk weights by LVR band under the current framework for IRB ADIs.

Figure 6. Risk weights for low LVR mortgages under the IRB approach



The average IRB outcomes by LVR band capture a range of risk estimates for individual loans. In particular, IRB estimates are more dynamic through the life of the loan, for example, they are more responsive to a change in borrower circumstances or movements in the credit cycle. Standardised risk weights generally do not change over the life of a loan. For an IRB ADI, the lowest risk weight is generally applied to loans that have significantly prepaid ahead of schedule. A low LVR loan on the standardised approach is not necessarily assigned the lowest risk weight under the IRB approach at origination.

APRA is not proposing to include dynamic factors in determining risk weights under the standardised approach for the following reasons:

- the standardised approach is intended to be simple and aligned with Basel III. For the standardised approach, APRA considers it more appropriate to focus on origination rather than behavioural variables as this has more influence on the quality of the portfolio and leads to less procyclical capital requirements; and
- the average difference between standardised and IRB capital outcomes is much narrower at the point of origination, which is the key point for competition. While the difference between standardised and IRB capital outcomes could widen over the life of the loan, APRA has ensured that the difference in average portfolio outcomes remains appropriate.

That said, APRA is proposing to implement a 5 per cent risk-weight floor for residential mortgage exposures under the IRB approach, to act as a simple backstop in ensuring capital outcomes do not widen at the lower risk segment of the portfolio. This is consistent with the approach taken by other jurisdictions and will limit the difference in capital outcomes between the standardised and IRB approaches for lower risk exposures.[10] This risk-weight floor is in addition to other factors that will reduce the difference in capital outcomes between standardised and IRB ADIs, such as the higher CCB for IRB ADIs and lower CCF estimates for standardised ADIs.

[10] For example, the UK Prudential Regulation Authority, *Consultation Paper CP14/20 Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture*, https://www.bankofengland.co.uk/prudential-regulation/publication/2020/internal-ratings-based-uk-mortgage-risk-weights-managing-deficiencies-in-model-risk-capture.

Chapter 5 - Proportionality and simplicity

In applying proportionality and simplicity in its design of the capital reforms, APRA is seeking to minimise regulatory burden from the revisions to the capital framework. This includes considering ways to increase efficiency for ADIs by simplifying requirements where this presents low risks to prudential safety and by lessening operational complexity in meeting APRA's requirements. In particular APRA proposes to apply a proportionate approach to capital and reporting requirements for small, less complex ADIs.

5.1 Enhancing proportionality

On account of their lower scale, the costs of complying with APRA's prudential framework represent a higher proportion of operating costs for smaller ADIs. Where APRA can lessen areas of regulatory burden without compromising on the financial safety of an individual ADI, this could enhance efficiency and improve overall outcomes for the financial system. The February 2018 discussion paper set out APRA's proposals for a simplified framework for small, less complex ADIs. Those proposals simplify non-credit related capital requirements where a proportionate approach could lead to efficiency gains for those ADIs while presenting low risks to prudential safety. APRA has identified further areas that may be subject to a proportional approach, either by requiring a simpler capital treatment or reducing the scope of regulatory reporting requirements. These include:

- expanding the eligibility threshold for the simplified framework from $15 billion in total assets to $20 billion in total assets;
- for the simplified framework, removing reporting requirements for counterparty credit risk and the qualitative requirements previously proposed for IRRBB;[11]
- removing the proposed leverage ratio capital and reporting requirement for all standardised ADIs; and
- other simplifications to the standardised approach to credit risk.

In proposing these initiatives APRA is lessening the compliance burden for ADIs and is aiming to realise benefits to the financial system from increasing efficiency for standardised ADIs, particularly smaller ADIs.

[11] For more information, see *Interest rate risk in the banking book for ADIs* (Response Paper, September 2019) https://www.apra.gov.au/consultations-on-revisions-to-capital-framework-for-authorised-deposit-taking-institutions.

Box 3 - APRA's proposals for a simplified framework for smaller ADIs

APRA is proposing a simplified framework for small, less complex ADIs. Simple, domestic ADIs with total assets below $20 billion would be eligible for this simplified framework. Eligible ADIs would not be subject to risk-based capital requirements for certain non-credit risks, but rather a simpler approach proportional to the size, complexity and interconnectedness of that cohort of ADIs. The proposed elements of this framework are:

- retention of APS 112 to determine capital requirements for credit risk;
- application of a flat operational risk add-on of 10 per cent of RWA;
- limiting IRRBB requirements to regulatory reporting;
- removal of counterparty credit risk and not applying the proposed leverage ratio requirements; and
- removal of the requirement for ADIs to make public disclosures under *Prudential Standard APS 330 Public Disclosure* with APRA making centralised disclosures for these ADIs.

5.2 Simplicity

In proposing revisions to the capital framework APRA has sought to align with the Basel III framework and where appropriate, adjust for Australian conditions, including to achieve the strengthening of capital consistent with 'unquestionably strong' capital benchmarks. In implementing these adjustments, APRA proposes to apply these in a simple and transparent manner. This includes:

- applying scalars to RWA outcomes under the IRB approach so APRA's adjustments to IRB risk estimates are clear to stakeholders; and
- constraining IRB estimates for certain portfolios, such as non-retail, to reduce operational complexity.

Implementing the Basel III framework itself introduces some complexity and burden, most notably the capital floor, which requires IRB ADIs to report their capital outcomes under the standardised approach. APRA considers that the benefits to the financial system from increased international and domestic comparability and compliance with the international framework outweigh the costs of calculating the capital floor for IRB ADIs.

To simplify capital calculations, and in turn, capital floor calculations, APRA is proposing that RWA for the New Zealand banking subsidiaries of ADIs be calculated under Reserve Bank of New Zealand (RBNZ) rules for the determination of Level 2 group capital requirements. This is a simpler approach that removes the operational burden of duplicate reporting systems for ADIs with exposures subject to RBNZ capital requirements.