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John F. Laker AO
CHAIRMAN

30 November 2010

Committee Secretary
Senate Economics References Committee
Department of the Senate
PO Box 6100 Parliament House
CANBERRA ACT 2600

Dear Sir,

INQUIRY INTO COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

This letter and submission have been written to assist the Senate Economics References Committee in its inquiry into competition within the Australian banking sector.

APRA's comments are limited to the following matters (adopting the same lettering as the terms of reference):

(g) regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis;

(h) opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers; and

(k) comparisons with relevant international jurisdictions.

By way of background, APRA's core mandate is to establish and enforce prudential standards and practices to ensure that, under all reasonable circumstances, promises made by regulated financial institutions are met. APRA does not have responsibility for competition policy outside this mandate although the *Australian Prudential Regulation Authority Act 1998* does require APRA to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality in the prudentially regulated sector and, in balancing these objectives, to promote financial system stability in Australia.

The thrust of APRA's submission is that the prudential supervision framework in Australia applies, with few exceptions, to banks, building societies and credit unions equally. Where it does not, there are prudential policy considerations – longstanding in one case – that justify a degree of differentiation. Overall, APRA does not consider that the prudential framework or its risk-based approach to supervision act as an impediment to a competitive banking system in Australia.

APRA staff would be happy to appear before the Committee if that would be helpful.

Yours sincerely,

John Laker

Australian Prudential Regulation Authority

Inquiry into competition within the Australian banking sector

Submission to the Senate Economics References Committee

30 November 2010

INQUIRY INTO COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

I. Introduction

APRA's core mandate is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the financial institutions it supervises are met within a stable, efficient and competitive financial system. In carrying out its functions, the *Australian Prudential Regulation Authority Act 1998* requires APRA to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia. APRA does not have any specific responsibility for competition in the banking sector outside this mandate.

This submission outlines the major components of the prudential supervision framework for authorised deposit-taking institutions (ADIs) in Australia. In the main, ADIs comprise banks, building societies and credit unions. With few exceptions, the prudential supervision framework applies equally to all ADIs. Where it does not, there are prudential policy considerations that justify a degree of differentiation but, in APRA's view, the differentiation does not act as an impediment to a competitive banking system in Australia. In its ongoing supervisory activities, APRA undertakes the same degree of supervisory oversight of a building society or credit union of a given size and risk profile as it would a bank of equivalent size and profile.

As at end June 2010, there were 174 ADIs in Australia. The current composition of the ADI sector[1] is shown in Table 1. Credit unions dominate the ADI sector by number but Australian-owned banks hold the vast bulk of assets.

Table 1: Composition of ADI sector in Australia: June 2010

	Number	Assets ($A billion)
Australian-owned banks	12*	2,071
Subsidiaries of foreign banks	9	106
Branches of foreign banks (foreign ADIs)	34	223
Building societies	11	24
Credit unions	108	49
TOTAL	**174**	2,473

*Includes Bank of Western Australia, a subsidiary of the Commonwealth Bank of Australia

Source: data for banks sourced from the June 2010 *Monthly Banking Statistics* publication. Data for credit unions and building societies sourced from the June 2010 *Quarterly Credit Union and Building Society Performance Statistics* publication

[1] Excluding 'other ADIs', which are specialist credit card providers and purchased payment facilities providers

II. The prudential framework for the ADI sector

The prudential supervision framework for ADIs in Australia has three core elements:

- the *Banking Act 1959* (the Banking Act);
- prudential standards and reporting standards issued by APRA; and
- prudential practice guides (PPGs) issued by APRA.

The Banking Act charges APRA with the obligation to protect the depositors of ADIs and to promote financial system stability in Australia. It requires that any entity that wishes to conduct banking business in Australia be authorised by APRA to do so. The obligations and requirements of the Banking Act apply equally to all ADIs. Financial institutions that wish to provide retail financial services, but seek to fund themselves other than through the taking of deposits, are generally able to operate without needing to be authorised as an ADI.

The Banking Act also gives APRA the power to determine prudential standards for ADIs. Prudential standards are legislative instruments issued by APRA, subject to Parliamentary disallowance, which have the force of law. APRA may, under the Banking Act, direct an ADI to comply with a prudential standard if it is not otherwise doing so, and may take enforcement action if it believes *inter alia* that the ADI may become unable to meet its obligations, may suspend payment or it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors and financial system stability. APRA's general approach is that prudential standards apply equally to all ADIs. There are, however, some exceptions to this, which are detailed below.

PPGs are non-binding guidance material designed to help ADIs understand and comply with APRA's prudential framework. In particular, they guide ADIs on how they might best meet the requirements of a common standard, taking into account their individual circumstances.

III. Authorisation

Under the Banking Act, it is an offence to carry on banking business in Australia unless APRA has granted either authorisation or exemption. 'Banking business' is defined as a business that consists of both taking money on deposit (other than as part-payment for goods or services) and making advances. Financial service providers operating outside this definition (such as mortgage lenders or finance companies that are not funded by deposits) are neither authorised nor regulated by APRA. In simple terms, therefore, an ADI authority can best be thought of as a licence to take deposits from the public.

In accordance with APRA's *ADI Authorisation Guidelines*,[2] an Australian-owned entity seeking to carry on banking business in Australia must satisfy APRA that, taking account of the scale, nature and complexity of its proposed operations, it:

- has sufficient start-up capital;

[2] http://www.apra.gov.au/ADI/upload/ADI-Guidelines-11-4-08.pdf

- can comply with ongoing capital adequacy requirements;

- meets the shareholding requirements of the *Financial Sector (Shareholdings) Act 1998* (FSSA);[3]

- meets APRA's governance requirements with regard to the composition and functioning of its board;

- has appropriate compliance, risk management and internal control systems;

- has appropriate information and accounting systems; and

- has in place arrangements with external auditors in accordance with APRA's prudential standards.

The only distinction in the authorisation process between types of ADIs relates to the use of the term 'bank'. Under Section 66 of the Banking Act, APRA's consent is required for use of the restricted terms 'bank', 'banker' and 'banking'. Under a 2000 class consent, APRA allows building societies and credit unions to use the adjective 'banking' in descriptors of their financial business. However, under APRA's authorisation and Section 66 guidelines, the noun 'bank' or 'banker' can only be used in the business names of ADIs that have APRA's approval to do so and hold at least $50 million in Tier 1 capital. (This minimum requirement has been in place since 1992.) Currently, there are five building societies and 20 credit unions with more than $50 million in Tier 1 capital that could seek APRA's approval to use the term 'bank' in their business name, but none has chosen to do so.

Overseas-authorised banks can apply for authorisation to conduct banking business in Australia as a locally incorporated subsidiary or a branch (some have chosen to have both types of presence). These applicants must additionally:

- obtain consent from their home supervisor to establish banking operations in Australia;

- satisfy APRA that they are subject to adequate prudential supervision in their home country; and

- demonstrate that their arrangements for reporting to the parent foreign bank or head office are adequate.

Foreign banks that choose to establish branch operations are not required to maintain capital in Australia and are not subject[4] to the depositor protection mechanisms of the Banking Act, which provide for depositors to be given priority over other creditors in the event that the bank is wound up. As a result, the branches are prevented from accepting initial deposits of less than $250,000 from individuals other than non-residents or their own employees. Foreign branches therefore tend to confine their operations to non-retail activities.

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[3] Under the FSSA, the shareholding in an ADI of an individual or group of associated shareholders is limited to 15 per cent of the entity's voting shares, unless otherwise approved by the Treasurer on national interest grounds. Substantial shareholders must also satisfy APRA that they are well-established, financially sound with a long-term commitment to the ADI and can contribute additional capital if required.

[4] By virtue of section 11E of the Banking Act

The United States, United Kingdom, Singapore, New Zealand and Canada also have quantitative and qualitative bank authorisation requirements similar to Australia, albeit with some variations in minimum start-up capital and ongoing capital adequacy ratios. The various requirements are listed in Attachment A.

Unlike Australia, credit unions and building societies in other jurisdictions are quite often subject to separate prudential requirements and, in some cases, are regulated by different agencies.[5] For example, credit unions and building societies may be allowed to hold lower amounts of start-up capital but this is offset by restrictions on the type of borrowing and lending they can undertake. Attachment A provides more detail.

IV. APRA's prudential requirements

APRA's prudential requirements are built upon the key planks of:

- capital adequacy;
- liquidity;
- governance; and
- risk management.

As a principles-based regulator, APRA seeks to achieve sound prudential outcomes wherever possible without specifying or prescribing the exact manner in which those outcomes must be achieved. APRA recognises that what may be appropriate and necessary for a large, internationally active bank may not be suitable for a small, regional-based institution. Principles-based regulation recognises the complexity and diversity that exists among regulated entities.

In carrying out its supervisory activities, APRA adopts a risk-based approach. Thus, it allocates direct supervisory resources and activities to areas of greatest risk or impact. The intensity of supervisory oversight is dependent on an ADI's size and risk profile rather than its categorisation as a bank, credit union or building society. Inevitably, the largest ADIs are subject to the most intense level of supervision.

Taking account of the size and risk profile of an ADI, APRA deploys a range of supervisory methods, including financial and statistical analysis, desktop reviews and intensive on-site reviews focusing on particular risk areas or topics. APRA aims to identify key risks, intervene early where necessary and ensure appropriate resolution strategies are implemented.

Capital adequacy

Capital is the cornerstone of an ADI's financial strength and provides a buffer to absorb unanticipated losses. APRA has broadly adopted the global capital adequacy regime of the Basel Committee on Banking Supervision (BCBS), under

[5] This was the case in Australia before reforms in 1999 brought credit unions and building societies under APRA's supervision as ADIs.

which ADIs must hold capital of at least eight per cent of risk-weighted assets.[6] However, APRA may require a higher prudential capital ratio (PCR) if it deems this to be necessary.

The current Basel Framework (known as Basel II) was implemented in Australia from the beginning of 2008, before the height of the global financial crisis. This Framework requires ADIs to hold regulatory capital against credit risk, operational risk and market risk (Pillar 1) and introduces a supervisory review process that seeks to ensure that ADIs have adequate capital to support all the risks in their business and to encourage them to develop and use better risk management techniques (Pillar 2). Pillar 3 of the Framework requires disclosure to allow market participants to assess key information such as risk exposures, risk assessment processes and capital adequacy.

The Basel II Framework 'provides a range of options for determining the capital requirements for credit risk and operational risk to allow [ADIs] and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructure'.[7] Thus ADIs have a choice between two broad methodologies for calculating their capital requirements for credit risk - the 'standardised approach' or the 'internal ratings-based (IRB) approach'. For operational risk calculations, a 'standardised approach' or the 'advanced measurement approaches (AMA)' are available,[8] although APRA expects any ADI seeking to adopt the IRB approaches to credit risk to also adopt the AMA for operational risk. APRA's Basel II requirements are set out in a series of prudential standards and prudential practice guides.[9]

The standardised approaches are, in effect, the default methodologies for determining an ADI's capital adequacy. APRA will only grant approval to an ADI to use the IRB and AMA approaches if it is satisfied that the ADI's internal rating and estimation systems and risk management framework are sufficiently robust to facilitate capital calculations that are sound, relevant and verifiable. That is, approval is based on the ADI's capabilities rather than its size. The IRB approach allows the ADI to use its own internal modelling to assist in quantifying, aggregating and managing credit risks across geographic and product lines. Only five ADIs – the major banks and Macquarie Bank – currently have approval to use the advanced approaches (advanced ADIs).

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[6] This approach was also implemented for credit unions and building societies by the State-based regulatory regime that existed prior to APRA's establishment.

[7] *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, Comprehensive Version: June 2006 (Basel II Framework), paragraph 7: http://www.bis.org/publ/bcbs128.htm

[8] A third methodology, the Basic Indicator Approach, was not adopted by APRA.

[9] *Prudential Standard APS 110: Capital Adequacy (APS 110); Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111); Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112); Prudential Standard APS 113: Internal Ratings-based Approach to Credit Risk (APS 113); Prudential Standard APS 114: Standardised Approach to Operational Risk (APS 114) and Prudential Standard APS 115: Advanced Measurement Approaches to Operational Risk (APS 115).* Advanced ADIs must also hold Pillar 1 capital against interest rate risk in the banking book under *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs) (APS 117)* and are subject to *Prudential Standard APS 150 Capital Adequacy: Basel II Transition (Advanced ADIs) (APS 150)*

In Australia, all other ADIs utilise the standardised approaches and calculate credit risk and operational risk capital charges based on the default Basel II formulae, as set out in APRA's prudential standards.[10]

In a June 2003 announcement of transition guidelines for Basel II implementation, APRA noted:

> 'that the conversion to Basel II will create a number of positive impacts for financial institutions in Australia. IRB banks, for example, may be able to operate with lower average capital requirements if they operate a low-risk business. Conversely, higher risk business would result in increased capital requirements.
>
> ADIs will also benefit from lower capital requirements attached to conventional home lending. This would lead to the need to hold additional capital for operational and, in some cases, interest rate risk. ADIs adopting standardised models are likely to experience a small decline in average capital levels.
>
> APRA does not expect the different approaches in Basel II to produce markedly different competitive impacts compared to the present rules.'[11]

These expectations have been borne out. Broadly speaking, the implementation of Basel II resulted in reductions of capital for advanced ADIs of between zero and 10 per cent,[12] and averaged around five per cent for standardised ADIs.

The differential impacts on capital requirements for advanced and standardised ADIs are a result of different approaches to calculating risk-weighted assets. Take credit risk, for example. Regulatory capital for credit risk is intended to reflect the risk that a loan might not be repaid. Different types of loans are assigned risk weightings based on their relative riskiness. Thus, residential mortgage lending is considered to be less risky than unsecured corporate loans and is given a lower risk-weighting. The actual risk weights may differ between the standardised and advanced approaches. For example, under the standardised approach, the Basel II Framework replaced the original concessional risk-weight of 50 per cent for a residential mortgage loan meeting certain conditions with a 35 per cent risk-weight.[13] Advanced ADIs, however, use their internal models (as approved by APRA), which are designed to reflect more accurately the risks of the individual ADI's mortgage portfolio than the 'one size fits all' standardised approach. The resulting risk-weights are often lower than those applying to standardised ADIs.

It would be incorrect, however, to consider the standardised and IRB credit risk weights to be directly comparable. For one thing, ADIs using the standardised

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[10] APS 112 and APS 114

[11] http://www.apra.gov.au/media-releases/03_54.cfm

[12] APRA imposed a maximum capital benefit on advanced ADIs from moving from Basel I to Basel II of 10 per cent (i.e. the maximum reduction in minimum capital requirements from the change in methodology was 10 per cent). No such floor applies to ADIs using the standardised approach.

[13] Under APS 112, standardised ADIs apply risk-weights of between 35 per cent and 100 per cent for residential mortgage loans. Thus a mortgage with a loan-to-valuation ration (LVR) below 60 per cent is weighted at 35 per cent while one with an LVR of over 100 per cent is risk-weighted at 100 per cent.

approach in Australia generally do not have a high degree of geographic or product diversification and tend to have relatively greater business/strategic and credit concentration risks than the larger, more diversified institutions using the advanced approaches. For another, advanced ADIs are subject to other capital requirements that are not applied to ADIs adopting the standardised approaches. For example, APRA requires advanced ADIs to hold capital against interest rate risk in the banking book.[14] APRA also currently requires advanced ADIs to hold at least 90 per cent of the amount of regulatory capital that was required under the original Basel regime;[15] standardised ADIs are not subject to such a limitation.

Hence, comparing the specific risk-weight for a particular loan under the two approaches will give a misleading impression of the overall impact of the Basel II Framework.

Many ADIs have used securitisation as an important source of funding and capital management.[16] One feature of recent securitisations, however, is that the originating ADI has retained all, or nearly all, of the most subordinated tranche(s), where credit risks associated with the securitisation transaction are concentrated. Longstanding prudential policy, in Australia and globally, is that ADI originators can only claim regulatory capital relief on securitisations if there has been significant credit risk transfer to third parties. In reviewing recent securitisations, APRA found that some originating ADIs had been applying this policy appropriately while others had not. Against this background, APRA wrote to ADIs in August 2010 restating its policy in this area and clarifying those features of securitisations that would not be consistent with the requirements for capital relief.[17]

Liquidity

APRA's current prudential framework for liquidity risk requires each ADI to have a liquidity management strategy that is appropriate for the operations of that ADI, i.e., a strategy that ensures that the ADI has sufficient liquidity to meet its obligations as they fall due.[18] The strategy should set out how the ADI measures, manages and assesses its liquidity position and how it is able to respond to a liquidity crisis.

In addition, an ADI must conduct scenario analysis on a regular basis to assess and measure its liquidity position under different operating circumstances. The two sets of scenarios specified in APRA's prudential standard are a business-as-usual or 'going concern' scenario and a 'name crisis' scenario. The purpose of the first scenario is to assess the ADI's ability to meet its obligations under normal operating conditions. The second scenario is one in which the ADI confronts adverse circumstances specific to it and, as a consequence, has significant difficulty in rolling over or replacing its existing liabilities. For this scenario, the ADI must be able to demonstrate that it is capable of operating for at least five business days in a crisis. In other words, the ADI's cumulative net cash flow position over the five-day period must be positive, taking into account any expected cash inflows

[14] APS 117

[15] APS 150, paragraph 10

[16] *Prudential Standard APS 120 Securitisation*

[17] http://www.apra.gov.au/adi/upload/Securitisation-Letter-to-ADIs-FINAL-26-August-2010.pdf

[18] *Prudential Standard APS 210 Liquidity (APS 210)*

from realising liquid assets and other funding sources that would be available to the ADI in that situation.

APRA's prudential framework, however, allows it to exempt smaller ADIs with simple business models from the scenario analysis requirements where APRA is of the view that the nature and scale of the ADI's operations do not warrant employing sophisticated cash-flow modelling techniques for liquidity risk management. Instead, the ADI will be subject to a simple quantitative metric – APRA's minimum liquidity holdings (MLH) requirements – under which the ADI must maintain at least nine per cent of its liabilities in specified high quality liquid assets at all times.[19] Most credit unions and building societies, and some smaller banks, have received an exemption to apply this approach.

Other requirements

APRA's prudential requirements for governance[20] and risk management[21] apply equally to banks, credit unions and building societies. Under these, the board of directors is responsible for the sound and prudent management of an ADI, including defining its risk appetite and implementing a risk management framework that is appropriate to the nature, scale and complexity of its operations. All ADIs are also expected to have appropriate audit measures and a board-approved remuneration policy for 'responsible persons' in the institution.

Prudential standards also exist for fitness and propriety,[22] large exposures,[23] associations with related entities,[24] outsourcing,[25] and business continuity management.[26] Again, these standards apply to all ADIs equally. As principles-based standards, however, there is scope for APRA to respond to genuine concerns from ADIs that believe they have sound reasons for not meeting a specific requirement in the standards.

V. Basel III reforms

In response to the commitment of the G-20 Leaders to strengthen the foundations of the global banking system, the BCBS announced a comprehensive reform program now known as 'Basel III'.[27] Details of these reforms to global capital and liquidity requirements are provided in Attachment B.

In brief, reforms to strengthen global capital requirements give much greater weight to common equity in the capital base, raise the minimum requirements for

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[19] A high quality liquid asset (HQLA) is one which is readily marketable with good credit quality. Therefore assets which are unencumbered and easily converted into cash within two business days are usually considered as HQLA. These mainly are cash, deposits with other ADIs and securities eligible for repurchase with the Reserve Bank of Australia (such as banks bills and certificates of deposit issued by ADIs with a minimum credit rating).

[20] *Prudential Standard APS 510 Governance (APS 510)*

[21] *Prudential Standard APS 310 Audit and Related Matters (APS 310)*

[22] *Prudential Standard APS 520 Fit and Proper (APS 520)*

[23] *Prudential Standard APS 221 Large Exposures (APS 221)*

[24] *Prudential Standard APS 222 Associations with Related Entities (APS 222)*

[25] *Prudential Standard APS 231 Outsourcing (APS 231)*

[26] *Prudential Standard APS 232 Business Continuity Management (APS 232)*

[27] http://www.bis.org/list/basel3/index.htm

common equity substantially and restricts the types of instruments that can count as regulatory capital. A stricter approach to deductions from capital will also apply. Two new capital buffers will be introduced: a capital conservation buffer and, if needed, a countercyclical capital buffer. A leverage ratio has also been introduced as a back-stop measure. The capital reforms are to be implemented on a staged basis, starting on 1 January 2013.[28]

As part of the development of the Basel III capital and liquidity reforms, a number of ADIs participated in a quantitative impact study (QIS) conducted by the BCBS. From the results of the QIS, APRA does not expect that the more stringent global capital regime will have significant implications for ADIs in Australia, which remained well-capitalised throughout the global financial crisis. For some years, APRA has adopted more conservative capital requirements than the original Basel minima; as a result, ADIs in Australia are well-placed to meet the requirements of the new regime. The QIS suggests that the main impact of the Basel III capital reforms will fall on the larger ADIs, due to (i) their higher usage of structured capital instruments that will no longer be eligible as regulatory capital, and (ii) a larger impact from the tighter definition of capital deductions. Overall, APRA does not anticipate standardised ADIs being materially affected by the capital reforms.

Reforms to strengthen liquidity risk management seek to promote stronger liquidity buffers (both in quality and quantity) to ensure that banking systems are more resilient to liquidity stresses.[29] The BCBS has introduced, for the first time, two internationally consistent regulatory standards for liquidity risk supervision. The first, the Liquidity Coverage Ratio (LCR), aims to promote short-term resilience by ensuring that banking institutions have sufficient high-quality liquid resources to survive an acute stress scenario lasting for one month. The second, the Net Stable Funding Ratio (NSFR), aims to promote longer-term resilience by creating additional incentives for banking institutions to fund their activities with more stable sources of funding (e.g. deposits or long-term debt) on an ongoing structural basis. The LCR will be introduced on 1 January 2015 and the NSFR on 1 January 2018.

Australia cannot meet the LCR standard as originally proposed, because the supply of Commonwealth Government Securities and other eligible liquid assets are limited in Australia. These circumstances have been recognised by the Basel Committee, and APRA and the Reserve Bank have been working closely with fellow Committee members on this issue. However, there are no unique circumstances to justify a departure from the NSFR global standard in Australia and that standard, once finalised, will be implemented by APRA in its globally agreed form.

In anticipation of the Basel Committee's liquidity reforms, APRA released a consultation package in September 2009 on its proposed enhancements to its prudential framework for ADI liquidity risk management.[30] The key changes involved more demanding stress-testing parameters; introduction of a standardised reporting framework to improve APRA's ability to assess ADIs' liquidity risk profiles under both normal and stressed conditions; and enhanced qualitative requirements

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28 http://www.bis.org/publ/bcbs180.htm

29 http://www.bis.org/publ/bcbs165.htm

30 http://www.apra.gov.au/Policy/Enhancing-prudential-framework-for-ADI-liquidity-risk-management.cfm

consistent with the Basel Committee's revised *Principles for Sound Liquidity Risk Management and Supervision* of September 2008.[31]

The proposed enhanced stress-testing requirements are not intended to apply to credit unions and building societies currently subject to MLH requirements. The MLH regime has, through the global financial crisis, delivered an appropriate degree of resilience for ADIs with relatively straight-forward, retail-based business models. Accordingly, APRA intends to retain that regime for these ADIs. However, APRA will continue to take a risk-based approach in determining whether any credit union or building society with a more complex business model should remain exempt from the stress-testing regime.

VI. Conclusion

APRA's prudential framework applies with few exceptions to all ADIs, whether they are banks, building societies or credit unions. In years past, for example, a number of building societies have converted to banks and their capital and other prudential requirements have not changed as a result. Under the Basel II Framework, advanced ADIs are subject to capital adequacy requirements that may allow them to hold lower capital against certain types of exposures; however, they are also subject to other capital requirements that are not applied to standardised ADIs.

In sum, APRA does not consider that its prudential framework for ADIs or its supervisory approach is a material factor in the competitive balance between different types of ADIs.

No new prudential requirements were imposed on ADIs in Australia by APRA during the global financial crisis. However, over the next few years, a comprehensive global banking reform package known as Basel III will be implemented in Australia and globally. Preliminary assessments and QIS results suggest that these reforms, though not material in their impact on the ADI sector overall, will have more of an impact on the capital and liquidity arrangements of the larger ADIs than on the smaller ADIs.

APRA's prudential framework does allow for new banking competitors. Over the past decade, a small number of competitors have joined the ADI sector, mainly subsidiaries or branches of foreign banks. The banking industry globally is consolidating, and APRA is not aware of any aspect of its prudential framework that discourage the entry of new participants of substance.

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[31] http://www.bis.org/publ/bcbs144.htm

Overseas entry requirements

Regulatory Authority	Authorisation Basics
US: Federal Reserve and Office of the Comptroller of the Currency (OCC)	A Guide to the National Banking System § 3.6 Minimum capital ratios • Total assets leverage ratio: Banks rated composite 1 under the Uniform Financial Institutions Rating System (CAMELS) rating system of banks must maintain Tier 1 capital in an amount equal to at least 3 per cent of adjusted total assets. • Additional leverage ratio requirement: Banks *not* rated composite 1 under CAMELS must maintain a minimum Tier 1 leverage ratio of 4 per cent. Although the OCC does not stipulate a minimum capital amount for national banks, the Federal Deposit Insurance Commission (FDIC) requires a bank to hold a minimum of US$2 million to be included in the deposit insurance scheme. This amount is effectively a de facto minimum for banks and for a federal savings association. National Credit Union Administration Loans to members (page 31): Loans cannot exceed 15 years, 10 per cent of the CU's capital and surplus, nor exceed an interest rate of 15 per cent per year on the unpaid balance inclusive of all finance charges. In addition, a member may repay a loan prior to maturity on any business day without penalty.
European Union: European Commission; UK: Financial Services Authority (FSA)	Directive 2006/48/EC (Title II - Article 9 - pg 21) Minimum capital: €5m or €1m under certain conditions. Minimum capital: • Banks: €5m • Building societies: €1m or £1m whichever is higher Capital adequacy: a Tier 1 capital ratio of 4 per cent and a total capital ratio of 8 per cent. Building Societies Act 1997 (c. 32) Lending limit: At least 75 per cent of the total assets of a building society must be fully secured on residential property. To count towards the 75 per cent limit, property must either be owner-occupied or let. Funding Limit: At least 50 per cent of building societies' funds must be raised in the form of shares held by individual members of the society. This may be reduced to 25 per cent only by order of the Treasury. Credit Unions Initial minimum capital: • Version 1 CU: at least £1,000. • Version 2 CU: at least £5,000. Capital adequacy (CRED 8.3): • £5m total assets or more than 5,000 members must have a capital to total assets ratio of at least 5 per cent. • £10m total assets or more than 10,000 members must have a risk-adjusted capital to total assets ratio of at least 8 per cent. Lending Limits (CRED 10.3): • Version 1 CU: must not lend for a period of more than 5 years where unsecured and 10 years where secured. A CU must not

	lend more than £15,000 in excess of the borrowing member's shareholding, nor can it lend more than £7,500 in excess of the borrowing member's shareholding unless it has a capital to total assets ratio of at least 5 per cent. • Version 2 CU: must not lend for a period of more than five years where unsecured and 25 years where secured. A CU must not lend more than £15,000 in excess of the borrowing member's shareholding, or 1.5 per cent of total shares in the credit union in excess of the borrowing member's shareholding, whichever is the greater. Funding (CRED 7.3): The borrowing of a version 1 credit union must not exceed, except on a short-term basis, an amount equal to 20 per cent of the total shareholding in the credit union.
Singapore: Monetary Authority of Singapore (MAS)	Banking Act (Part III - Licensing of Banks) Minimum capital requirement (Section 9): • Locally incorporated > $1,500m • Outside incorporated > $200m • Subsidiaries > $100m Risk based capital requirements (Section 10.2): • Capital adequacy ratio > 12 per cent Co-operative Societies Act (Part IV - Property and funds) Capital: No minimum, only to be sourced from member shares and entrance fees. The issue of bonds or debentures by a society shall be subject to the approval of the Registrar. Lending: Only to a member and their immediate family, an employee, or another society with approval. Borrowing: Can only borrow under such conditions as may be prescribed by its by-laws and in the Rules.
New Zealand: Reserve Bank of New Zealand (RBNZ)	Bank Registration Information (page 13) Minimum capital: $30m Capital adequacy: At least 8 per cent total capital and 4 per cent tier one capital. Non-bank deposit takers (in force 1 Dec 10) Capital adequacy: At least 8 per cent total capital (if rated) or 10 per cent total capital (if unrated). Currently no minimum entry requirements for NBDTs. The RBNZ does not monitor BS or CU for compliance with these requirements; that is the task of the trustee.

Canada: Office of the Superintendent of Financial Institutions (OSFI)	Incorporation Guide Minimum capital: \$5m (or greater if specified) (Section 6.1) Capital adequacy: a Tier 1 capital ratio of 4 per cent and a total capital ratio of 8 per cent. Cooperative Credit Associations Borrowing multiple: Total borrowings should be no greater than 20 times capital. The Superintendent has the authority to approve up to 23 times capital. Commercial Lending Limits: Commercial lending limit: 5 per cent of total assets if cooperative credit associations have a capital base less than \$25m.

Basel III reforms

In July 2009, the Basel Committee on Banking Supervision (BCBS) approved a package of measures to strengthen the 1996 rules governing trading book capital and to enhance the three pillars of the Basel II Framework. The measures involve:

- the introduction of higher capital requirements to capture the credit risk of complex trading activities and the introduction of a stressed value-at-risk (VaR) requirement;
- higher risk-weights for resecuritisation exposures to better reflect the risk inherent in these products, and increasing the credit conversion factors for short-term liquidity facilities provided to off-balance sheet conduits;
- Pillar 2 guidance on valuation practices and the capture of off-balance sheet and securitisation activities; and
- strengthening Pillar 3 disclosure requirements for securitisations and off-balance sheet exposures, including resecuritisation activities.

In December 2009, the BCBS released a consultation package of proposals to strengthen the resilience of the banking sector. The reforms cover a number of key areas and include proposals to:

- raise the quality, consistency and transparency of the capital base to better absorb losses on both a going concern and a gone concern basis;
- strengthen the risk coverage of the capital framework. In addition to the trading book and securitisation reforms announced in July 2009, the BCBS is proposing to strengthen the capital requirements for counterparty credit risk[32] exposures arising from derivatives, repos and securities financing activities. The strengthened counterparty capital requirements will also increase incentives to move over-the-counter (OTC) derivative exposures to central counterparties and exchanges;
- introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework to help contain the build-up of excessive leverage in the banking system and safeguard against model risk and measurement error;
- introduce a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress. In addition, the BCBS is promoting more forward-looking provisioning based on expected losses, which captures actual losses more transparently and is also less procyclical than the current "incurred loss" provisioning model; and
- introduce two global minimum liquidity standards for internationally active banks – a short-term (30-day) stress testing requirement (Liquidity Coverage Ratio or LCR) and a longer-term structural liquidity requirement (Net Stable Funding Ratio or NSFR).

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[32] Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.