Response to Submissions

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

November 2012

Preamble

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) released a package of reforms, known as Basel III, to raise the level and quality of regulatory capital in the global banking system. In September 2011, the Australian Prudential Regulation Authority (APRA) released a discussion paper, *Implementing Basel III capital reforms in Australia,* outlining its proposals to implement the major elements of these reforms in Australia. This was followed by draft prudential and reporting standards released in March and June 2012, respectively. Final versions of prudential and reporting standards implementing the Basel III reforms to the quality and consistency of regulatory capital for authorised deposit-taking institutions (ADIs) were released in September 2012.

Following publication of the Basel Committee's refinements to the Basel III counterparty credit risk measures, in August 2012 APRA released a discussion paper, *Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures.* This paper also outlined proposals to implement other aspects of the Basel Committee's reforms that were not included in APRA's previous consultation packages. Also released were draft prudential standards, reporting standards and prudential practice guides incorporating APRA's proposals.

This paper responds to submissions received on the proposals outlined in the August consultation package. APRA is also releasing final versions of 12 prudential standards, two prudential practice guides, seven reporting standards and revised guidelines relating to external credit assessment institutions. These standards and guidance come into effect from 1 January 2013.

This response paper and the final prudential and reporting standards and guidance are available on APRA's website at www.apra.gov.au/adi/Pages/adi-consultation-packages.aspx.

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Glossary

ADI	Authorised deposit-taking institution
Advanced ADIs	ADIs approved to use the advanced Basel II approaches to measuring risk for capital adequacy purposes.
APRA	Australian Prudential Regulation Authority
APS 112	*Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
APS 113	*Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*
APS 120	*Prudential Standard APS 120 Securitisation*
Basel Committee	Basel Committee on Banking Supervision
Basel III	*Basel III: A global regulatory framework for more resilient banks and banking systems* – revised version June 2011, Basel Committee, June 2011, and *Capital requirements for bank exposures to central counterparties,* Basel Committee, 25 July 2012.
CCP	Central counterparty – a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts.
Clearing member	A member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.
Custodian	A trustee, agent, pledgee, secured creditor or any other person that holds property in a way that meets the following conditions: • the custodian does not have a beneficial interest in that property; and • the property will not become subject to legally enforceable claims by either the custodian or its creditors, or to a court-ordered stay of the return of such property, should the custodian become insolvent or bankrupt.
CVA	Credit Value Adjustment
EAD	Exposure at default, as defined in APS 113, which corresponds to the term 'credit equivalent amount' (CEA) in APS 112.
ECAI	External Credit Assessment Institution

Initial margin	A clearing member's or client's funded collateral posted to the CCP to mitigate the Potential Future Exposure (PFE) of the CCP to the clearing member arising from the possible future change in the value of their transactions. For the purposes of this discussion paper, initial margin does not include contributions to a CCP for mutualised loss-sharing arrangements (i.e. if a CCP uses initial margin to mutualise losses among the clearing members, it will be treated as a default fund exposure).
Internal Model Method (IMM)	Under both the existing Basel framework and Basel III, banks with approval to use the Internal Model Method may use their internal model to estimate Exposure at Default for counterparty credit risk for capital purposes. The IMM is not currently part of APRA's prudential framework.
IRB	Internal ratings-based approach to credit risk
Margin period of risk	The estimated time period from the last exchange of collateral covering a netting set of transactions with a defaulting counterparty until that counterparty is closed out and the resulting market risk is re-hedged.
OTC	Over-the-counter. An OTC derivative is a derivative transaction other than an exchange-traded derivative, i.e. negotiated between two parties rather than through an exchange. Some examples are interest rate swaps and forward rate agreements.
PPG	Prudential Practice Guide
QCCP	Qualifying CCP. An entity that is licensed to operate as a CCP (including a licence granted by way of confirming an exemption), and is permitted by the CCP's regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO *Principles for Financial Market Infrastructures.*
Specific wrong-way risk	A future exposure to a specific counterparty that is highly correlated with the counterparty's probability of default. For example, a company writing put options on its own stock creates wrong-way exposures for the buyer that are specific to the counterparty.
Standardised ADIs	ADIs using the standardised Basel II approaches to measuring risk for capital adequacy purposes.
Variation margin	A clearing member's or client's funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.

Executive summary

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) released a package of reforms to raise the level and quality of regulatory capital in the global banking system (Basel III), including reforms to the capital framework for counterparty credit risk. APRA has been formally consulting on its proposed implementation of these reforms since September 2011, culminating on the release in September 2012 of final prudential and reporting standards implementing the major elements of Basel III that raise the quality and consistency of regulatory capital. This response paper finalises APRA's implementation of the Basel III counterparty credit risk measures and those reforms that were not included in the September 2012 release.

Since release of the Basel III rules text in December 2010, the Basel Committee has made further refinements to its counterparty credit risk rules, the latest being the interim rules set out in *Capital requirements for bank exposures to central counterparties*[1], released on 25 July 2012. In August 2012, APRA released a discussion paper outlining its proposals to implement these and other Basel III reforms in Australia, together with draft standards and reporting forms (the August package). Five submissions were received on the counterparty credit risk proposals in the package.

Basel III counterparty credit risk requirements

APRA intends to adopt the minimum Basel III requirements for the definition and measurement of counterparty credit risk capital, except in certain areas where there are strong pragmatic reasons to either allow for a simplified approach or continue APRA's existing approach.

Where possible, APRA has provided further guidance in response to issues raised in submissions. The Basel Committee continues to receive questions related to the interpretation of the Basel III counterparty credit risk rules text, and APRA has referred a number of issues to the Basel Committee for further consideration. APRA expects there will be further guidance from the Basel Committee in the form of updated 'frequently asked questions' documents. However, APRA does not expect that the rules text as incorporated in its prudential and reporting requirements will change.

Other Basel III reforms

The August consultation package also included APRA's proposals to implement other aspects of the Basel III measures to raise the quality, consistency and transparency of the capital base, to give effect to proposals relating to covered bonds and securitisations and to address other minor matters.

APRA has also sought comments on its proposed implementation of the Basel III measures relating to disclosure requirements for the use of external credit assessment institutions (ECAIs) for regulatory capital purposes. This response paper addresses comments made on this matter and is accompanied by revised guidelines on the recognition of ECAIs for capital adequacy purposes.

Implementation

APRA is releasing, with this response paper, final prudential standards and prudential practice guides (PPGs) that give effect to the remaining Basel III capital reforms. It is also releasing revised APRA reporting standards and reporting forms for both ADIs and consolidated banking groups under the *Financial Sector (Collection of Data) Act 2001*. These standards and PPGs take effect from 1 January 2013.

1 http://www.bis.org/publ/bcbs227.htm

Chapter 1 – Introduction

1.1 Overview

In its December 2010 document *Basel III – A global regulatory framework for more resilient banks and banking systems,* the Basel Committee released a package of reforms to raise the level and quality of regulatory capital in the global banking system[2]. This comprehensive reform package included measures:

- to raise the quality, consistency and transparency of the capital base and harmonise other elements of capital; and
- to improve the risk coverage of the Basel II Framework by strengthening the capital requirements for counterparty credit risk exposures arising from banks' derivatives, repurchase and securities financing activities. Further details on this reform were announced in June and July 2012.

APRA's proposed implementation of these reforms was outlined through the following consultation and response packages:

- discussion paper, *Implementing Basel III capital reforms in Australia,* September 2011[3];
- response papers and draft prudential and reporting standards released in March and June 2012, respectively[4];
- discussion paper, *Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures*[5]*,* draft prudential and reporting standards, released in August 2012 (the August package); and
- response paper, *Implementing Basel III capital reforms in Australia*[6], final prudential and reporting standards, released in September 2012 (the September 2012 package);

This paper finalises APRA's response to issues raised on the August and September packages, including comments on draft prudential standards, reporting standards and guidance. Accompanying this paper are final versions of these documents:

- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112);
- *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113);
- *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116);
- *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (APS 117);
- *Prudential Standard APS 120 Securitisation* (APS 120);
- *Prudential Standard APS 220 Credit Quality* (APS 220);
- *Prudential Practice Guide APG 112 Standardised Approach to Credit Risk* (APG 112);
- *Prudential Practice Guide APG 113 Internal Ratings-based Approach to Credit Risk* (APG 113);
- *Reporting Standard ARS 112.1 Standardised Credit Risk – On-balance Sheet Exposures* (ARS 112.1);
- *Reporting Standard ARS 112.2 Standardised Credit Risk – Off-balance Sheet Exposures* (ARS 112.2);
- *Reporting Standard ARS 113.4 Internal Ratings-based Approach (IRB) to Credit Risk – Other Assets, Claims and Exposures* (ARS 113.4);
- *Reporting Standard ARS 116.0 Market Risk* (ARS 116.0);
- *Reporting Standard ARS 117.0 Repricing Analysis* (ARS 117.0);
- *Reporting Standard ARS 120.0 Standardised Approach – Securitisation* (ARS 120.0);
- *Reporting Standard ARS 120.1 Internal Ratings-based Approach (IRB) – Securitisation* (ARS 120.1); *and*
- *Guidelines on Recognition of an External Credit Assessment Institution* (the ECAI guidelines).

2 The final text (revised in June 2011) is at: http://www.bis.org/publ/bcbs189.htm

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

4 http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-March-2012.aspx and http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-capital-reforms-reporting-requirements-June-2012.aspx

5 http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Counterparty-Credit-Risk-and-other-measures-August-2012.aspx

6 http://www.apra.gov.au/adi/PrudentialFramework/Pages/Implementing-Basel-III-capital-reforms-in-Australia-September-2012.aspx

As foreshadowed in the September 2012 response paper, APRA is also releasing updated versions of other prudential standards to incorporate minor cross-referencing and terminology changes flowing from its implementation of Basel III. These prudential standards are:

- *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk* (APS 114);
- *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* (APS 115);
- *Prudential Standard APS 221 Large Exposures* (APS 221);
- *Prudential Standard APS 310 Audit and Related Matters* (APS 310);
- *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (APS 330); and
- *Prudential Standard APS 610 Purchased Payment Facility Providers* (APS 610).

1.2 Structure of the paper

Chapter 2 outlines APRA's response to issues raised in submissions on APRA's counterparty credit risk proposals. In Chapter 3, APRA responds to submissions on the other Basel III measures outlined in the August package and to submissions received on its proposals relating to ECAIs.

1.3 Investments in commercial entities

APRA's policy position on investments in commercial entities outlined in the September 2012 response paper, is inconsistent with the prudential standards released on 30 September 2012. APRA confirms the policy position outlined in the response paper and will shortly release a corrected version of *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital.*

Chapter 2 – Counterparty credit risk

APRA received five submissions on specific aspects of the counterparty credit risk proposals. APRA's response to issues raised in submissions is set out below.

Submissions requested a number of concessional treatments. As a general matter, APRA seeks to ensure that its prudential capital framework is consistent with global standards. APRA therefore intends to adopt the minimum Basel III requirements for the definition and measurement of counterparty credit risk capital, except in certain areas where there are strong pragmatic reasons to either allow for a simplified approach or continue APRA's existing approach. In particular:

- APRA has implemented only the simpler of the two calculation methods for capital requirements for default fund contributions to qualifying central counterparties set out in the Basel III reforms;
- ADIs with immaterial over-the-counter (OTC) counterparty credit risk exposure may be permitted by APRA to use a simplified approach to calculate the credit valuation adjustment (CVA) risk capital requirement; and
- APRA has not introduced the Internal Model Method (IMM) into the capital adequacy framework.

Where possible, APRA has provided further guidance in response to issues raised in submissions. The Basel Committee continues to receive questions related to the interpretation of the Basel III counterparty credit risk rules, and APRA has referred a number of issues to the Basel Committee for further consideration. APRA expects that there will be further guidance from the Basel Committee in the form of updated 'frequently asked questions' documents that will provide clarification of existing rules.

2.1 CVA risk capital charge

2.1.2 Calculating the CVA risk capital charge

APRA proposed to adopt the Basel III framework in respect of the CVA risk capital requirement, with the exception that, for pragmatic reasons, ADIs with immaterial OTC counterparty credit risk exposure may be permitted by APRA to use a simplified approach to calculate the CVA risk capital requirement.

Comments received

Submissions sought clarification on whether an ADI is permitted to apply exemptions to the one-year floor when determining weighted average maturity for the purposes of calculating the CVA risk capital charge.

APRA response

Consistent with the Basel III rules text, the calculation of effective maturity in the CVA risk capital charge formula may be determined according to paragraphs 33 to 37 of Attachment B to *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113), with the exception that the five-year cap does not apply. Exemptions from the one-year floor will apply according to the provisions set out in paragraphs 38 to 41 of that Attachment.

2.2 Capitalising exposures to qualifying central counterparties (QCCPs)

2.2.1 Determining QCCPs

Draft *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) requires an ADI to apply different capital treatments to exposures depending on whether the exposure is to a qualifying or non-qualifying central counterparty. A qualifying CCP (QCCP) is an entity that is licensed to operate as a central counterparty (CCP) (including a licence granted by way of confirming an exemption) and that is permitted by the CCP's regulator/overseer to operate as such with respect to the products offered. This is subject to the requirement that the CCP must be based in a jurisdiction where the relevant regulator/overseer has established, and will maintain, domestic rules and regulations that are consistent with the CPSS-IOSCO *Principles for Financial Market Infrastructures.*

Comments received

Submissions sought further guidance on the procedure for distinguishing between qualifying and non-qualifying CCPs and queried whether APRA and/or other regulators would maintain and publish a list of QCCPs.

APRA response

APRA does not intend compiling a list of QCCPs and believes it is for ADIs to make their own determination, using the criteria set out in paragraph 9(x) of APS 112. An ADI will be required to provide APRA with a list of CCPs to which it has exposures and, if requested, its basis for determining that a CCP is qualifying.

2.2.2 Calculation of trade exposures to QCCPs

APRA proposed to adopt the Basel III framework whereby an ADI's trade exposures to a QCCP would be exempt from the CVA risk capital charge where the ADI acts as a clearing member to that QCCP. Such exposures would instead be subject to a much lower risk-weight (two per cent) than bilateral exposures, reflecting the assumption of a very low risk of default for a QCCP.

Comments received

Submissions sought advice about:

- the scope and definition of trade exposures to QCCPs; and
- the treatment of netting in respect of exposures to central counterparties.

APRA response

Under the definition of trade exposures (paragraph 9(cc) of APS 112), the scope of trade exposures to QCCPs encompasses exchange-traded derivatives exposures, including futures transactions on established exchanges.

Trade exposures to a QCCP are equal to the current exposure (replacement cost) plus the potential future exposure of a clearing member or a client of a clearing member to a QCCP arising from OTC derivatives, exchange-traded derivatives or securities financing transactions, plus the initial margin posted by the ADI, plus the variation margin due to the ADI from the CCP but is not yet received.

Immediately after a variation margin call the replacement cost is set to zero, and the trade exposure is equal to the initial margin posted by the ADI to the QCCP, plus the variation margin due to the ADI from the QCCP but is not yet received, plus the potential future exposure. Thereafter, until the next variation margin call, there will be an additional replacement cost where the position valuation has moved in the ADI's favour.

For the purposes of calculating trade exposures for a clearing member to a QCCP, the netting rules of Attachment J to APS 112 apply also to exchange-traded derivatives. These rules include the requirement, under paragraph 7 of that Attachment, that an ADI must have the right to terminate and close-out, in a timely manner, all the transactions under the netting agreement in the event that the QCCP fails to perform due to default, liquidation or bankruptcy or other similar circumstances.

2.2.3 Clearing member trade exposures to QCCPs

The two per cent risk-weight on a ADI's trade exposure to a QCCP also applies to QCCP exposure that arises where the clearing member guarantees that its client will not suffer any loss due to changes in the value of its transactions in the event that the QCCP defaults.

Comments received

Submissions sought further clarification of the capital treatment that would apply.

APRA response

A clearing member is not considered to have exposure arising from its client's exposures to a QCCP where the clearing member is under no obligation to reimburse that client for any loss suffered due to changes in the value of its transactions in the event that the QCCP defaults.

2.2.4 QCCP clearing member trade exposures to clients

APRA proposed to adopt the Basel III framework in respect of QCCP clearing members' exposure to clients under which exposures to clients would be treated as bilateral trades, albeit with a lower capital requirement than other bilateral trades.

Comments received

Submissions sought clarification of the capital treatment that would apply.

APRA response

Consistent with the Basel III framework, a clearing member to a QCCP may capitalise the exposure to its clients by multiplying the exposure at default (EAD) by a scalar of no less than 0.71, where the risk reduction varies from 0.71 to 1.0 as a function of the margin period of risk. However, the clearing member must estimate the margin period of risk, taking into account all relevant effects that may slow down the collateral process.

2.2.5 Treatment of collateral posted for exposures to QCCPs

APRA proposed to adopt the Basel III approach to collateral posted to a QCCP. This requires an ADI (either as a clearing member or a client of a clearing member) posting collateral to risk-weight those assets, regardless of the fact that such assets have been posted as collateral. In addition, APRA proposed that an ADI must apply risk-weights to posted collateral reflecting the circumstances under which the collateral is held and the creditworthiness of the entity holding the collateral.

Comments received

Submissions queried the treatment of collateral posted to a QCCP and, in particular, whether this may be subject to a zero risk-weight.

APRA response

Collateral posted to a QCCP will not be eligible for a zero risk-weight under paragraph 26 of Attachment C to APS 112.

2.2.6 Capital charges for default fund exposures to QCCPs

Given the interim nature of the rules and to reduce complexity, ARPA proposed to implement only the simpler of the two methods set out in the Basel III reforms for calculating capital for default fund contributions to a QCCP.

Comments received

Submissions from industry expressed a desire to also have the option of implementing the approach referred to as 'Method 1' under the Basel III framework. Submissions noted the uncertain impact of the proposal not to allow Method 1 and the potential for that approach to provide greater incentives to join better-funded CCPs.

APRA response

Given the interim nature of the rules and the ongoing development of instructions from the Basel Committee on the calculations required for the risk-sensitive approach, APRA remains of the view that it is appropriate to implement the simple approach only. APRA anticipates that the Basel Committee will release final default fund capital charge rules in 2014 and intends to review the default fund capital rules at that time.

2.3 Capitalising exposures to non-qualifying central counterparties

APRA proposed to adopt the Basel III framework whereby an ADI's trade exposures to a non-qualifying CCP would be subject to a CVA risk capital charge where the ADI acts as a clearing member to that CCP. Such exposures would be subject to the same risk-weight as bilateral exposures.

Comments received

Submissions sought advice about:

- the scope and definition of trade exposures to non-qualifying CCPs; and
- the treatment of netting in respect of exposures to non-qualifying CCPs.

APRA response

Trade exposures to a non-qualifying CCP are calculated in the same manner as for a QCCP, as described in section 2.2.2 above. However, trade exposures to a non-qualifying CCP are risk-weighted according to the creditworthiness of the non-qualifying CCP, using the standardised credit risk framework as described in APS 112, subject to the CVA risk capital charge.

The treatment of netting in respect of exposures for a clearing member to a non-qualifying CCP is the same as for a clearing member to a QCCP, as described in section 2.2.2 above.

2.4 Other matters

2.4.1 Asset value correlation (AVC)

APRA proposed that an advanced ADI be required to increase the correlation (R) (described in Attachment B to APS 113) by multiplying it by 1.25 in respect of exposures to financial institutions whose assets exceed USD 100 billion and to unregulated financial institutions (including financial institutions or leveraged funds not subject to prudential solvency regulation). This change would apply to all sources of credit risk exposure, not only counterparty credit risk. For the purpose of determining asset value correlation, 'regulated financial institution' is defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international practice. This includes, but is not limited to, prudentially regulated insurance companies, broker-dealers, banks, thrifts and futures commission merchants.

Comments received

Submissions asked whether other financial entities would be caught by this definition and for confirmation about the threshold currency.

Submissions also sought clarification on whether the correlation for small unregulated financial institutions is to be determined according to paragraph 77 of Attachment B to APS 113 (dealing with unregulated financial institutions) or paragraph 81 of Attachment B to APS 113 (dealing with small institutions).

APRA response

An ADI may also classify ADIs, insurance companies and friendly societies regulated by APRA as 'regulated financial institutions'. However, superannuation funds and QCCPs are excluded. APRA also clarifies that the threshold value will be AUD 100 billion.

Until further guidance is provided by the Basel Committee, ADIs are to apply the treatment in paragraph 77 of Attachment B to small unregulated financial institutions.

2.4.2 Minimum holding periods to apply when calculating collateral haircuts

APRA proposed that, when determining the minimum holding periods to use when calculating collateral haircuts, an ADI must apply a higher minimum holding period than the minimum set out in Table 11 of Attachment H to draft APS 112 in the following circumstances:

- for all netting sets where the number of trades exceeds 5,000 at any point during a quarter, the minimum holding period must be set to 20 business days for the following quarter;
- for netting sets containing one or more trades involving either illiquid collateral or an OTC derivative that cannot be easily replaced, the minimum holding period must be set to 20 business days; and
- if an ADI has experienced more than two margin call disputes on a particular netting set over the previous two quarters that have lasted longer than the applicable minimum holding period (before consideration of this provision), the minimum holding period must be at least double the supervisory floor for that netting set for the subsequent two quarters.

Comments received

Submissions sought clarification as to whether the minimum holding periods apply to both standard and own-estimate haircuts and sought further guidance regarding the terms 'illiquid collateral' and 'OTC derivatives that cannot easily be replaced'.

APRA response

The minimum holding periods and associated conditions set out in Table 11 and paragraph 39 of Attachment H to APS 112 apply to both own-estimate and standardised haircuts. In addition to the guidance included in APG 112, further guidance will be sought from the Basel Committee regarding the terms 'illiquid collateral' and 'OTC derivatives that cannot easily be replaced'.

2.4.3 Foreign exchange contracts with original maturity less than 14 calendar days

In draft APS 112, APRA proposed to remove the exemptions from risk-weighting for foreign exchange contracts that have an original maturity of 14 calendar days or less and instruments traded on futures and options exchanges that are subject to daily mark-to-market and margin payments.

Comments received

Submissions sought an explanation of why APRA proposed to remove the exclusion of FX contracts with original maturities of less than 14 calendar days.

APRA response

Under Basel I, ADIs were permitted to exclude FX contracts with original maturity of less than 14 calendar days from the calculation of capital for counterparty credit risk. Consistent with the Basel III framework, which allows no such exclusions from counterparty credit risk capital calculations, this provision has been removed from APS 112.

2.4.4 Disclosure requirements

Part of the Basel III reforms include revised public disclosure requirements under Pillar 3.

Comments received

APRA received two submissions seeking clarification as to whether there would be enhanced public disclosure requirements for the new counterparty credit risk capital measures.

APRA response

APRA will be reviewing ADIs' Pillar 3 requirements in the first half of 2013 to give effect to Basel Committee measures on public disclosure of capital and remuneration. Any potential amendments in respect of counterparty credit risk will be addressed as part of that review.

2.4.5 Internal Model Method (IMM)

APRA proposed not to introduce the IMM into the prudential framework when the Basel III reforms come into effect from 1 January 2013. However, APRA noted that it remains willing to consider the adoption of the IMM in the future and that it intended to continue to review ADIs' approaches to counterparty credit risk management and measurement during 2013.

Comments received

Some submissions sought clarification of APRA's approach to, and expectations for, the introduction of the IMM approach.

APRA response

APRA has not changed its position on the implementation of the IMM. It intends to provide further clarification of its expectations regarding the IMM when it reviews ADIs' approaches to counterparty credit risk management and measurement during 2013.

2.4.6 Specific wrong-way risk

Under the current APS 113, an advanced ADI must have documented policies regarding the treatment of individual entities in a connected group, including the circumstances under which the same rating may or may not be assigned to some or all related entities. In draft APS 113, it was proposed that these policies must include a process for the identification of specific wrong-way risk for each legal entity to which the ADI is exposed.

Comments received

Some submissions sought confirmation that APRA's proposed treatment of specific wrong-way risk was consistent with Basel III.

APRA response

APRA confirms that, under Basel III, advanced ADIs are required for internal reporting purposes to identify instances of specific wrong-way risk. However, as ADIs are not currently permitted to use the IMM for capital purposes, there is no requirement for an ADI to modify the capital calculation to reflect the identified specific wrong-way risk.

2.5 Transitional arrangements

APRA proposed that, consistent with the Basel III internationally agreed timetable, the new counterparty credit risk rules would take effect from 1 January 2013.

Comments received

Several submissions requested that APRA consider transitional relief in view of the short implementation timeframe and the extent of other regulatory reforms.

APRA response

As a member of the Basel Committee, APRA is committed to adopting the Basel III reforms in line with the internationally agreed timetable. Nevertheless, APRA is mindful of:

- the relatively short time between the Basel Committee's release of the final counterparty credit risk measures and their effective date; and
- the additional reporting requirements for ADIs that take effect from that date.

With these factors in mind, APRA proposes that ADIs prepare counterparty credit risk capital calculations on a 'best endeavours' basis until their first annual reporting period beginning on or after 1 July 2013.

APRA notes that OTC derivatives markets are currently subject to considerable regulatory change and, for some CCPs, the CCP supervision regime necessary to achieve qualifying status may not be in place from 1 January 2013. APRA will therefore consider allowing transitional arrangements when considering the qualifying status of central counterparties, where it is satisfied that such arrangements raise no prudential concerns.

Chapter 3 – Other amendments

APRA received a number of submissions on its proposals to implement other aspects of the Basel III capital reforms.

3.1 Securitisation

3.1.1 Subordinated tranches

In November 2011, APRA released a discussion paper, *Covered bonds and securitisation matters*[7], which included a proposal to require an ADI to deduct from Common Equity Tier 1 Capital an exposure in the trading or banking book to a subordinated tranche of a securitisation originated by an entity other than the ADI or an extended licensed entity of the ADI. The proposed definition of a 'subordinated tranche' was 'any tranche of a securitisation that is exposed to the first 10 per cent of credit losses as a share of the initial capital structure, unless it is also the most senior tranche' ('the 10 per cent rule'). In its July 2012 response paper, *Covered bonds and securitisation matters*[8], APRA confirmed that it would adopt this securitisation proposal and provided the text of draft changes to *Prudential Standard APS 120 Securitisation* (APS 120) to give effect to the proposal.

Comments received

Submissions queried the impact of the 10 per cent rule on warehouse special purpose vehicles (SPVs).

APRA response

APRA notes the issues raised in relation to warehouse SPVs and will consider them as part of its full review of APS 120 in 2013. APRA has amended paragraph 29 of Attachment B to APS 120 such that it does not apply where an ADI holds a subordinated tranche in a warehouse SPV to which it has provided funding. However, ADIs should not assume that the exemption of warehouse structures will be other than a temporary measure pending further consultation as part of APRA's review of APS 120.

3.1.2 Risk-weighted assets

APRA proposed to adopt the Basel III treatment under which certain items, previously deducted 50:50 from Tier 1 and Tier 2 capital, are to be risk-weighted at 1250 per cent if held in the banking book. These items included the treatment of certain securitisation exposures, where no due diligence on underlying collateral is undertaken. APRA also proposed to apply a 100 per cent capital charge for such exposures held in the trading book.

Comments received

One submission was concerned that the inclusion of the same due diligence paragraph in both *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116) and APS 120 leads to a securitisation exposure that cannot satisfy the due diligence requirements being deducted twice – once for credit risk and again for market risk.

APRA comment

There have been no changes to either APS 116 or APS 120 in this area other than to accommodate the Basel III requirements that securitisation exposures for which the ADI does not conduct due diligence are no longer a 50:50 deduction from Tier 1 and Tier 2 capital. Securitisations held in the trading book are subject to APS 116 for capital purposes, not APS 120. Accordingly, capital requirements are not calculated twice for the same exposure.

However, APRA has amended the instructions in *Reporting Standard ARS 120.0 Standardised Approach – Securitisation* (ARS 120.0) and *Reporting Standard ARS 120.1 Internal Ratings-based (IRB) Approach – Securitisation* (ARS 120.1) to clarify that exposures held in the trading book are to be reported in accordance with *Reporting Standard ARS 116.0 Market Risk* (ARS 116.0), not under ARS 120.0 or ARS 120.1.

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

8 http://www.apra.gov.au/adi/PrudentialFramework/Documents/ADI_RS_CBSM_072012_ex.pdf

3.2 Treatment of cash collateral posted to third parties

APS 112 (paragraph 15 of Attachment H) precluded the recognition of cash collateral lodged with an entity other than the ADI, except where:

(a) the ADI and the entity holding the collateral belong to the same Level 2 group; and

(b) the entity holding the collateral is bound to act in accordance with the agreement between the ADI and the party lodging the collateral.

Comments received

One submission queried the risk-weighting applying to cash lodged with a custodian.

APRA response

Consistent with the treatment of other assets lodged with an eligible custodian, there is no counterparty credit risk on the custodian. However, the asset lodged as collateral is risk-weighted. For cash, unless the custodian holds it directly, the risk-weight is determined by reference to the entity with which the custodian has lodged that collateral. APRA has amended the wording of APS 112 to clarify this approach.

3.3 Trade finance

APRA proposed to adopt the Basel Committee's approach to trade finance, as set out in its October 2011 document, *Treatment of trade finance under the Basel capital framework*[9], by amending APS 112 to allow the one-year maturity floor to be waived for letters of credit used for the purposes of trade finance that have a maturity of less than one year and are self-liquidating.

Comments received

One submission proposed that other methods of trade financing (such as documentary collections and open accounts) should also be subject to waiver, commenting that letters of credit are declining in favour of these other methods.

APRA response

The Basel Committee's position is designed to improve access to, and lower the cost of, trade finance instruments for low-income countries. The rules text deliberately focuses on issued and confirmed letters of credit, which are of particular importance to such countries. Waiving the one-year maturity floor for other instruments is a matter of national discretion. APRA is not, as a matter of general policy, persuaded that other forms of trade finance facilities meet the intent of assisting low-income countries and therefore does not propose a general extension of the waiver. APRA will, however, consider doing so on a case-by-case basis where a trade financing facility is, from a risk perspective, in all but name the same as a letter of credit, including both the maturity and self-liquidating criteria.

3.4 Definition of 'financial institution'

Comments received

One submission queried the different definitions of 'financial institution' in *Prudential Standard APS 001 Definitions* (APS 001), in draft APS 112 and APS 113 for the purposes of defining a central counterparty and in draft *Prudential Standard APS 210 Liquidity* released for consultation in November 2011. It was suggested that the rationale for these differences was unclear and that conflicting definitions would cause identification and reporting difficulties and could increase the likelihood of error or incorrect data interpretation.

APRA response

APRA's definitions of 'financial institution' used for capital requirements – the APS 001 definition and that underpinning the counterparty credit risk requirements in APS 112 and APS 113 – are based on the Basel II and Basel III texts, respectively. The definition in draft APS 210 is deliberately somewhat broader. APRA does not propose a change in this approach. However, APRA has sought to more explicitly link the definitions back to APS 001, thus making the substantive differences between definitions clear. With regard to liquidity risk management, APRA's revised definition will be published in the next release of draft APS 210.

9 http://www.bis.org/publ/bcbs205.htm

3.5 Inconsistencies between credit quality prudential and reporting standards

Comments received

A concern was raised about inconsistencies between *Prudential Standard APS 220 Credit Quality* (APS 220) and *Reporting Standard ARS 220.0 Impaired Facilities* (ARS 220.0) in relation to the treatment of past due facilities.

APRA response

APRA will address this anomaly in 2013.

3.6 Associations with related entities

Comments received

One submission raised concern about APRA's proposal to add a provision to *Prudential Standard APS 222 Associations with Related Entities* (APS 222) under which APRA may, on a case-by-case basis, vary the limits that apply to exposures of ADIs to related parties.

APRA response

This proposal simply aligns APS 222 with *Prudential Standard APS 221 Large Exposures* by providing discretion to APRA to vary exposure limits in cases where the general limits are too high, given the nature of the exposures and other relevant factors. In this context, APRA notes that the current APS 221 and APS 222 limits are high by international standards. The Basel Committee is currently undertaking a full review of large exposure limits, given experience from the global financial crisis. Pending this review, APRA's intention is to facilitate a gradual shift to lower large exposures on a case-by-case basis.

3.7 External credit assessment institutions (ECAIs)

Comments received

In the September Basel III response paper, APRA outlined proposals to implement Basel III requirements relating to ECAIs by amending APRA's *Guidelines on Recognition of an External Credit Assessment Institution* (the ECAI guidelines) and APS 120. These proposed amendments incorporate additional international access/transparency and disclosure requirements based on the International Organisation of Securities Commissions' (IOSCO) *Code of Conduct Fundamentals for Credit Rating Agencies* (the IOSCO code).

It was submitted that the proposal under which an ADI, in determining capital requirements, may only use an ECAI assessment to determine capital requirements that is 'publicly available on a non-selective basis and free of charge' (from clause 3.4 of the IOSCO code) could conflict with conditions on some ECAIs' Australian Financial Services Licence (AFSL), which prevents the provision of credit assessments to retail investors.

APRA response

APRA acknowledges that there is a technical conflict between the two regulatory requirements. APRA notes, however, that the Basel approach is designed to ensure that credit assessments are not private but are available to industry participants. APRA accepts that such participants are unlikely to be retail investors and, therefore, proposes to amend its requirements to accommodate AFSL licensing conditions.

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