Discussion Paper

Implementing Basel III capital reforms in Australia

6 September 2011

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Australian Prudential Regulation Authority

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Preamble

This discussion paper outlines the Australian Prudential Regulation Authority's proposals to implement a package of reforms to strengthen the capital framework for authorised deposit-taking institutions (ADIs) in Australia. These reforms give effect to the measures announced by the Basel Committee on Banking Supervision (Basel Committee) in December 2010 to strengthen global capital rules so as to promote a more resilient global banking system. These measures are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* and are known as 'Basel III'. As a member of the Basel Committee, APRA has been actively involved in developing these global reforms and fully supports their implementation in Australia.

The Basel III framework also addresses other prudential matters such as global liquidity rules, which will be the subject of separate consultation. This discussion paper relates only to the Basel III capital requirements.

APRA invites written submissions on its proposals. Following consideration of submissions received, APRA will issue draft prudential standards and reporting requirements for consultation in early 2012. APRA intends to implement the Basel III capital requirements from 1 January 2013.

This discussion paper is available on APRA's website at www.apra.gov.au. Written submissions on the paper should be forwarded by 2 December 2011 by email to Basel3capital@apra.gov.au and addressed to:

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Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

Contents

Glossary

AASB 9	*AASB 9 Financial Instruments*
AASB 138	*AASB 138 Intangible Assets*
AASB 139	*AASB 139 Financial Instruments: Recognition and Measurement*
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 110	*Prudential Standard APS 110 Capital Adequacy*
APS 111	*Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*
APS 116	*Prudential Standard APS 116 Capital Adequacy: Market Risk*
APS 120	*Prudential Standard APS 120 Securitisation*
APS 330	*Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information*
Basel II Framework	*International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2006
Basel III	*'Basel III: A global regulatory framework for more resilient banks and banking systems'*, December 2010
Basel Committee	Basel Committee on Banking Supervision
CCB	Capital conservation buffer
CET1	Common Equity Tier 1
DvP	Delivery-versus-payment
G-20	Group of Twenty
GDP	Gross domestic product
GRCL	General reserve for credit losses
ICAAP	Internal capital adequacy assessment process
IFRS 13	*IFRS 13 Fair Value Measurement*
IRB	Internal ratings-based approach to credit risk
LGD	Loss given default
PCR	Prudential Capital Requirement (previously Prudential Capital Ratio)
PD	Probability of default
PPG	Prudential Practice Guide
PvP	Payment-versus-payment
QIS	Quantitative Impact Study
RBA	Reserve Bank of Australia
SPV	Special purpose vehicle
Standardised ADIs	ADIs using the standardised Basel II approaches to measuring risk for capital adequacy purposes

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). This discussion paper commences APRA's public consultation on these Basel III capital reforms.

APRA seeks to ensure that its prudential capital framework is consistent with global standards. APRA therefore proposes to adopt the minimum Basel III requirements for the definition and measurement of capital except in certain areas where there are strong in-principle reasons to continue APRA's current policies. Alignment will require APRA to take a stricter approach than at present in some areas but a less conservative approach in others.

The Basel III reforms also allow national supervisors to adopt a concessional treatment for certain other items in determining regulatory capital. APRA does not propose to exercise this discretion. A principal objective of APRA's prudential capital framework is to ensure that, for the protection of depositors and the stability of the Australian financial system, capital must be available to absorb losses in a gone-concern scenario (or leading up to that point). In addition, APRA's framework seeks to ensure that there is no double-counting of capital in the Australian financial system. The concessional treatment would not be consistent with these objectives. APRA therefore proposes to retain its longstanding policies in these areas.

A summary of the key proposals is provided below.

Minimum capital requirements

APRA proposes to adopt the Basel III definition of regulatory capital, under which common equity is the predominant form of Tier 1 capital. In addition, APRA proposes to adopt the Basel III minimum requirements for Common Equity Tier 1, Tier 1 and Total Capital, and the stricter eligibility criteria for Tier 1 and Tier 2 capital instruments.

Regulatory adjustments to capital

APRA proposes to adopt the Basel III regulatory adjustments to capital that are specified as minimum requirements, with only minor exceptions. Basel III takes a stricter approach than APRA in requiring deductions to be made from Common Equity Tier 1. APRA proposes to adopt this approach and to remove the 50:50 deduction rule in line with Basel III. At the same time, APRA proposes to revise some aspects of its existing requirements that are more conservative than the Basel III minimum requirements. Specifically, APRA proposes to align its treatment of expected dividends and of unrealised gains and losses recognised on the balance sheet with Basel III. The only exceptions to the Basel III minimum requirements will be that APRA will continue to require capitalised expenses and capitalised transaction costs to be deducted from capital; APRA will also take a more conservative approach in removing the double counting of capital in the financial system and on investments in commercial institutions.

The Basel III reforms also provide national supervisors with discretion to provide limited recognition of certain items in calculating Common Equity Tier 1. These items are deferred tax assets relating to 'temporary' (timing) differences, significant investments in the common shares of non-consolidated financial institutions, and mortgage servicing rights. APRA does not propose to apply this 'threshold treatment' but to require that these items be deducted in full from Common Equity Tier 1.

Capital conservation buffer

Basel III introduces a capital conservation buffer designed to ensure that ADIs build up capital buffers outside periods of stress that can be drawn down as losses are incurred. The capital conservation buffer is in addition to the minimum Common Equity Tier 1 requirement, and capital distribution constraints will be imposed on an authorised deposit-taking institution (ADI) when its capital levels fall within the buffer range. APRA is proposing to add the capital conservation buffer to the Prudential Capital Requirement (PCR) that it determines for each ADI, which may be at or above the Basel III minima. However, APRA will have regard to the cumulative impact of its capital requirements when determining the size of the capital conservation buffer to apply to each ADI.

Countercyclical buffer

Basel III also introduces a countercyclical buffer designed to ensure that banking system capital requirements take account of the macro-financial environment in which ADIs operate. It is intended that the buffer be imposed, through an extension of the capital conservation buffer, when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk. APRA proposes to introduce the countercyclical buffer regime in line with the Basel III reforms.

Leverage ratio

Basel III introduces a simple, transparent, non-risk based leverage ratio to help contain the build-up of leverage in the banking system and to safeguard against model risk and measurement error. APRA proposes to introduce this measure in its prudential capital framework in line with the Basel III reforms.

Disclosure

To improve the transparency of regulatory capital and market discipline, Basel III introduces new prudential disclosure requirements for the Basel III capital framework. APRA proposes to consult on these disclosure requirements when the Basel Committee releases more details.

Transitional arrangements

Basel III provides generous transitional arrangements for the new Basel III capital requirements, in respect of minimum capital ratios, deductions and capital instruments.

In APRA's view, ADIs in Australia are well placed to meet the new requirements and APRA therefore proposes to adopt an accelerated timetable in some areas. Under APRA's proposals:

- ADIs will be required to meet the revised Basel III minimum capital ratios and regulatory adjustments in full from 1 January 2013;
- APRA will adopt the Basel III phase-out arrangements for capital instruments that no longer qualify as Additional Tier 1 capital or Tier 2 capital. APRA will require outstanding noncomplying capital instruments to be phased-out no later than their first available call date, where one exists;
- the capital conservation buffer will apply in full from 1 January 2016. APRA is of the view that, with the transition allowance for capital instruments that no longer qualify as Tier 1 and Tier 2 capital, ADIs should be able to meet the combined Common Equity Tier 1 minimum requirement and the capital conservation buffer by that date;
- APRA will indicate in 2015 whether any countercyclical buffer will apply from 1 January 2016 and whether any phasing-in of that buffer is necessary; and
- APRA will introduce the leverage ratio on the Basel III timetable, which envisages this ratio migrating to a Pillar 1 requirement on 1 January 2018.

Consultation with industry and other interested stakeholders

APRA invites written submissions on its proposals to implement the Basel III capital reforms in Australia. It encourages all interested stakeholders to use this consultation opportunity to advise it of any implementation issues and to submit relevant cost-benefit analysis information.

Following consideration of submissions received, APRA will issue draft prudential and reporting standards and, where appropriate, prudential practice guides (PPGs) for consultation in early 2012, so as to allow ADIs to prepare for the implementation of the Basel III reforms from 1 January 2013.

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.[1] This comprehensive reform package included measures:

- to raise the quality, consistency and transparency of the capital base and harmonise other elements of capital;
- to improve the risk coverage of the Basel II Framework[2] by strengthening the capital requirements for counterparty credit risk exposures arising from banks' derivatives, repurchase and securities financing activities;
- to promote the build-up of capital buffers in good times that can be drawn upon in times of stress; and
- to introduce a leverage ratio as a supplementary measure to the risk-based Basel II Framework to help contain the build-up of excessive leverage in the banking system.

In a letter to ADIs on 17 December 2010[3], APRA expressed its full support for the Basel III reforms and indicated its intention to consult on them in 2011 and 2012. This discussion paper commences APRA's public consultation on those measures relating to the quality, consistency and transparency of capital, capital buffers and the leverage ratio. It does not address the Basel III capital treatment of counterparty credit risk, which will be the subject of separate consultation.[4]

The Basel Committee's December 2010 document provides the rules text for the definition and measurement of the minimum Basel III capital requirements. In the interests of international consistency, APRA proposes to incorporate these requirements into its prudential standards except in certain areas where there are strong in-principle reasons to continue APRA's current approach. The December 2010 document also provides a limited discretion to national supervisory agencies to apply a concessional treatment for certain items in the measurement of capital. APRA does not intend to exercise this discretion (and currently excludes these items from capital calculations), for reasons outlined in this paper.

The Basel III reforms are global minimum capital requirements for internationally active banks.[5] As with the implementation of the Basel II Framework, however, APRA proposes to apply the capital requirements to all ADIs. In APRA's view, the Basel III measures are prudentially sound, will improve the regulatory capital framework for ADIs and, by ensuring that all ADIs have adequate, high quality capital, will strengthen the protection available to depositors and the resilience of the Australian banking system as a whole.

1 The December text is at: www.bis.org/bcbs/basel3.htm.
2 *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (Basel II Framework) found at www.bis.org/publ/bcbs128.htm.
3 www.apra.gov.au/adi/Publications/Pages/other-information-for-adis.aspx.
4 In June 2011, the Basel Committee announced that it had completed its review of the Basel III capital treatment for counterparty credit risk in bilateral trades. The review resulted in a minor modification of the treatment proposed in the December 2010 document. Refer www.bis.org/publ/bcbs189.htm.
5 The application of the minimum Basel III requirements follows the existing scope of application set out in Part I of the Basel II Framework. Refer paragraph 47 of the Basel III text and paragraph 9 of the Basel II Framework.

APRA anticipates that, following consideration of submissions received, it will undertake a second consultation in early 2012 on the detailed prudential and reporting standards that will give effect to the Basel III capital reforms in Australia.

Continued application of the Basel II Framework

Under the Basel II Framework, APRA exercised a number of discretions in relation to the scope of application, Pillar 1 calculations and adjustments to risk-weighted assets. APRA believes the rationale for the exercise of those discretions is unchanged by the Basel III reforms and therefore APRA will continue to apply those discretions in the new prudential standards. Specifically, the Basel III requirements will be applied at both Level 1 and Level 2 unless APRA explicitly states otherwise[6]; the capital charge for interest rate risk in the banking book in Pillar 1 will continue to apply; and APRA will maintain its current requirements for the determination of risk-weighted assets.

1.2 Structure of the paper

Chapter 2 outlines APRA's proposals to implement the revised Basel III definition of capital, which requires the predominant form of minimum Tier 1 capital to be common equity, and the new minimum levels of regulatory capital. It also outlines APRA's proposals to ensure that all regulatory capital instruments are capable of absorbing loss.

Chapter 3 outlines APRA's proposed treatment of regulatory adjustments to capital and explains why APRA has chosen not to exercise its discretion to provide a concessional treatment for certain capital deductions.

Details of APRA's proposals for implementation of the capital conservation buffer, and the interaction between this buffer and the PCR that APRA sets for each ADI, are set out in Chapter 4. Chapter 5 provides details of the proposed leverage ratio while Chapter 6 addresses proposed revisions to disclosure requirements for ADIs. APRA's proposed transitional arrangements are discussed in Chapter 7.

APRA encourages ADIs to submit cost-benefit information as set out in Chapter 8.

6 Level 1 and Level 2 are defined in *Prudential Standard APS 110 Capital Adequacy* (APS 110).

Chapter 2 – Minimum capital requirements

The Basel III reforms introduce a definition of regulatory capital that gives greater weight to common equity than has applied under the Basel II Framework. Basel III also strengthens the criteria for inclusion of other instruments in Tier 1 and Tier 2 capital and takes a stricter approach to regulatory capital adjustments than Basel II. This chapter sets out APRA's proposals to implement these Basel III requirements.

2.1 Definition of capital

A key element of the Basel III reforms is the greater focus on common equity, the highest quality component of capital. Under the revised Basel III definition of capital, **total regulatory capital** consists of the sum of the following elements:

- Tier 1 capital (going-concern capital), comprising:
  - Common Equity Tier 1;
  - Additional Tier 1; and
- Tier 2 capital (gone-concern capital)

Under Basel III, the revised elements of capital are net of the associated regulatory adjustments (discussed in Chapter 3) and are subject to the following new limits and minima:

- Common Equity Tier 1 must be at least 4.5 per cent of risk-weighted assets at all times;
- Tier 1 capital must be at least six per cent of risk-weighted assets at all times; and
- Total Capital (Tier 1 capital plus Tier 2 capital) must be at least eight per cent of risk-weighted assets at all times.

Under the current *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111)[7], APRA employs a capital classification framework derived from the Basel II Framework. Total regulatory capital consists of:

- Tier 1 capital, comprising:
  - Fundamental Tier 1;
  - Residual Tier 1 (comprising innovative and non-innovative capital); and
- Tier 2 capital, comprising:
  - Upper Tier 2; and
  - Lower Tier 2.

Within this framework:[8]

- Tier 1 capital must be at least four per cent of risk-weighted assets at all times;
- Total Capital (Tier 1 capital plus Tier 2 capital) must be at least eight per cent of risk-weighted assets at all times;
- Tier 2 capital cannot exceed Tier 1 capital; and
- Lower Tier 2 capital cannot exceed 50 per cent of Tier 1 capital.

APRA proposes to replace the current components of capital and the related ratios and limits in APS 111 with the Basel III definitions, limits and minima for regulatory capital.

2.1.1 Common Equity Tier 1

Under Basel III, common equity is recognised as the highest quality component of capital. It is subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date. It is the primary form of funding that helps ensure that ADIs remain financially sound.

7 Paragraphs 6(a) and 6(b).
8 Tier 1, Tier 2 and Total capital are net of all specified deductions and amortisation as specified in APS 111.

The Basel III definition of Common Equity Tier 1 is comprised of the following elements:

- common shares;
- share premium;
- retained earnings;
- accumulated other comprehensive income;
- other disclosed reserves;
- minority interests (subject to certain criteria outlined in Appendix 5); and
- regulatory adjustments applied in the calculation of Common Equity Tier 1.

APRA proposes to adopt the Basel III definition of Common Equity Tier 1 to replace the concept of 'Fundamental Tier 1' in APS 111 paragraph 18(a). The requirements for Fundamental Tier 1 already reflect most of the Basel III requirements for Common Equity Tier 1. The proposed APRA definition of Common Equity Tier 1 will reflect other additional Basel III requirements, such as more detailed criteria for the classification of common shares.

Appendix 1 sets out the proposed criteria for classification as common shares for regulatory capital purposes.

In calculating Common Equity Tier 1, Basel III takes a less conservative approach than APRA to the treatment of two particular items:

- expected dividends; and
- unrealised gains and losses.

Consistent with its objective of introducing the Basel III minimum capital requirements except where there are strong in-principle reasons not to do so, APRA is proposing to bring its treatment of these two items into line with Basel III.

Expected dividends

Basel III provides for dividends to be removed from Common Equity Tier 1 'in accordance with applicable accounting standards'. In practice, this means that dividends are to be deducted when declared, which is usually after balance date. APS 111 adopts a more conservative approach, which requires expected current year dividends (net of an allowance for dividend reinvestment) to be deducted from retained earnings when determining Tier 1 capital. Since Basel III introduces higher minimum common equity requirements and a capital buffer that automatically restricts dividend payments when capital levels have been diminished, APRA proposes to adopt the Basel III treatment of dividends. That is, dividends will be deducted from retained earnings only after they have been declared.

Unrealised gains and losses

Basel III allows all unrealised gains and losses recognised on the balance sheet to be included in the determination of Common Equity Tier 1. In contrast, APRA's current treatment of unrealised gains and losses (excluding loans) allows:

- 100 per cent of liquid 'held for trading' unrealised gains and losses to be included in Fundamental Tier 1; and
- 45 per cent of unrealised pre-tax gains and losses in specified reserves to be included in Upper Tier 2 capital, subject to meeting specific eligibility criteria.

APRA proposes to amend its current approach to align with Basel III. That is, APRA proposes to follow the Basel III approach to allow unrealised gains and losses to be included in determining Common Equity Tier 1.[9]

9 The items previously included in APS 111 paragraphs 24 (h) and (i) will no longer be recognised in Tier 2 capital.

The reliability and robustness of fair values are crucial for capital adequacy purposes. APRA proposes that APS 111 will retain its requirements relating to the recognition of fair values. Moreover, to ensure that there is adequate transparency about the proportion of regulatory capital that comprises unrealised gains and losses, ADIs will be subject to additional reporting requirements, which will help APRA to monitor the impact of *AASB 9 Financial Instruments* (AASB 9) (when it comes into effect)[10] and the use of fair values. Appendix 2 provides further details on these reporting requirements, which will be additional to those required under *IFRS 13 Fair Value Measurement* (IFRS13) disclosures.[11]

The Basel Committee is continuing to review the treatment of unrealised gains and losses, taking into account the evolution of the accounting framework. APRA may amend its proposals should the outcome of this review lead to changes in the treatment of fair value adjustments in the calculation of Common Equity Tier 1.

Criteria for common shares for mutually owned ADIs

The criteria for classification as common shares in Common Equity Tier 1 is intended to apply to all ADIs, including mutually owned ADIs, taking into account their specific constitutional and legal structure. Basel III provides some scope for instruments other than 'common shares' to be recognised as part of Common Equity Tier 1. The Basel III rules text states that 'the application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress.'

There are a number of mutually owned ADIs that have issued instruments currently qualifying as Tier 1 capital. APRA invites submissions from these ADIs as to whether the features of the instruments will comply with the criteria for Common Equity Tier 1 (or Additional Tier 1 criteria, set out in section 2.1.2 below). APRA also invites submissions more generally on how new capital instruments issued by mutually owned ADIs could be deemed to be the equivalent of common shares (or Additional Tier 1 capital) in terms of their capital quality and loss absorption.

2.1.2 Additional Tier 1 Capital

The Basel III definition of Additional Tier 1 capital comprises the following elements:

- instruments issued by an ADI that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1. Appendix 3 provides the criteria for inclusion in Additional Tier 1 capital;
- share premium/stock surplus resulting from the issue of instruments included in Additional Tier 1 capital;[12]
- instruments issued by consolidated subsidiaries of the ADI and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1 (subject to criteria outlined in Appendix 5); and
- regulatory adjustments applied in the calculation of Additional Tier 1 capital.

10 AASB 9 is scheduled to come into effect for annual reporting periods beginning on or after 1 January 2015.

11 IFRS 13 is effective for annual reporting periods beginning on or after 1 January 2013.

12 Share premium that is not eligible for inclusion in Common Equity Tier 1 will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the share premium are permitted to be included in Additional Tier 1.

APRA supports the principle that non-common equity elements included in Tier 1 capital must be able to absorb losses while the ADI remains a going concern. To be considered loss absorbent on a going-concern basis, all instruments included in Additional Tier 1 will need to be subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.

APRA proposes that an instrument issued by an ADI must meet the Basel III minimum set of criteria to be included in Additional Tier 1 capital, as provided in Appendix 3. Significant changes from the current APS 111 requirements are the following:

- the provisions currently in APS 111 Attachment A allowing hybrid instruments in innovative Tier 1 capital will be removed;
- 'innovative' features such as step-ups or other incentives to redeem, which over time have eroded the quality of Tier 1, will not be allowed;
- although Additional Tier 1 capital instruments may be callable by the ADI after a minimum of five years from the date of issue, the ADI must not create an expectation that a call will be exercised. Additionally, any call must not be exercised unless the ADI replaces the called instrument with capital of the same or higher quality or the ADI demonstrates to APRA that its capital position will be well above its PCR after a call option is exercised;
- Additional Tier 1 capital instruments must meet the non-viability requirements (see also section 2.2); and
- Additional Tier 1 capital instruments classified as liabilities for accounting purposes must have principal loss absorption through a conversion or write-down mechanism that allocates losses to holders. APRA proposes that write-down or conversion be triggered when the issuing ADI's consolidated (i.e. Level 2) Common Equity Tier 1 ratio is at or below 5.125 per cent.[13] This is the lowest level at or below which any distributions on Tier 1 instruments under the capital conservation buffer regime are prohibited in the Basel III reforms.

APRA proposes that stapled securities may be eligible for inclusion as Additional Tier 1 capital where they meet the relevant criteria for such capital, including the loss absorption provisions (set out in section 2.2).

Payments on Additional Tier 1 instruments will be considered a distribution of earnings under the proposed capital conservation buffer regime (see Chapter 4). This will improve their loss absorbency on a going-concern basis by increasing the likelihood that dividends and coupons will be reduced or cancelled in times of stress as a result of the restrictions on distributions that apply through the application of the capital conservation buffer requirements.

13 Where an ADI is a stand-alone entity and is not part of the Level 2 group, the applicable benchmark will be the Level 1 Common Equity Tier 1 ratio.

2.1.3 Tier 2 capital

The Basel III definition of Tier 2 capital comprises the following elements:

- instruments issued by an ADI that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital. Appendix 4 provides the criteria for inclusion in Tier 2 capital;
- share premium/stock surplus resulting from the issue of instruments included in Tier 2 capital;[14]
- instruments issued by consolidated subsidiaries of the ADI and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital (subject to the criteria outlined in Appendix 5);
- certain loan loss provisions (see below); and
- regulatory adjustments applied in the calculation of Tier 2 capital.

The objective of Tier 2 capital is to provide loss absorption on a gone-concern basis. APRA supports this objective and proposes to simplify the Tier 2 framework in APS 111 in line with the Basel III criteria. The current categories of 'Upper' and 'Lower' Tier 2 will be removed and one set of criteria for eligible instruments is proposed (refer to Appendix 4).

Tier 2 capital instruments will need to meet the minimum criteria of being subordinated to depositors and general creditors and having an original maturity of at least five years. Recognition in regulatory capital will be amortised on a straight-line basis during the final five years to maturity. An ADI will not be allowed to exercise a call (after five years) unless the instrument is replaced with capital of the same or better quality or the ADI demonstrates to APRA that its capital position will be well above its PCR after the call option is exercised. APS 111 will be revised to reflect these minimum Basel III criteria.

General reserve for credit losses (GRCL) for ADIs using the standardised approach to credit risk

For ADIs using the standardised approach to credit risk, Basel III allows general provisions/general loan loss reserves in Tier 2 capital. APS 111 currently provides that a general reserve for credit losses held against future, but presently unidentified, losses that is freely available to meet losses that subsequently materialise qualifies for inclusion in Tier 2. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, are to be excluded. Under Basel III, the amount of any loan loss reserve eligible for inclusion in Tier 2 is limited to a maximum of 1.25 percentage points of *credit* risk-weighted assets calculated under the standardised approach. APS 111 paragraph 24(g)(i) currently limits the GRCL to 1.25 percentage points of *total* risk-weighted on- and off-balance sheet assets. APRA proposes to amend APS 111 to base the eligible limit for the GRCL on credit risk-weighted assets, in line with Basel III.

Excess of total eligible provisions under the advanced internal ratings-based (IRB) approach to credit risk

Under Basel III, ADIs using the advanced IRB approach to credit risk may recognise the difference between the amount of any loan loss reserve and expected losses (i.e. any provisions in excess of expected losses) in Tier 2 capital, up to a maximum of 0.6 per cent of credit risk-weighted assets. At national discretion, a limit lower than 0.6 per cent may be applied. APS 111 paragraph 24(g)(ii) already implements the Basel III requirement and APRA does not propose exercising its discretion to lower the 0.6 per cent limit.

14 Share premium that is not eligible for inclusion in Tier 1 will only be permitted to be included in Tier 2 if the shares giving rise to the share premium are permitted to be included in Tier 2 capital.

2.1.4 Criteria for inclusion in consolidated capital – minority interest and other capital issued by consolidated subsidiaries held by third parties

Under Basel III, minority interest arising from the issue of common shares by an ADI's subsidiary may be included in the ADI's consolidated Common Equity Tier 1 only if:

- the issuing subsidiary is itself an ADI (or overseas equivalent); and
- the issue meets the Basel III criteria for common shares (set out in Appendix 1).

Further, the amount that can be included is reduced by the surplus Common Equity Tier 1 of the subsidiary attributable to the minority shareholders, calculated as set out in Appendix 5.

The Basel III requirement is more restrictive than APRA's current requirement, which allows recognition in Fundamental Tier 1 capital at Level 2 of the full amount of minority interests arising from consolidation of common equity capital issued to third parties by subsidiaries consolidated in the Level 2 group.

Basel III also allows Additional Tier 1 and Tier 2 capital instruments issued to third-party investors by consolidated subsidiaries to be included in the Tier 1 and Tier 2 capital of the consolidated banking group (Level 2). This is on the basis that the instruments meet the criteria for classification as regulatory capital (set out in Appendices 3 and 4, respectively). The amount that can be included is reduced by the surplus capital of the subsidiary attributable to third-party investors in the Additional Tier 1 and Tier 2 instruments. Appendix 5 sets out how the amount that can be recognised is calculated.

APRA currently allows an ADI to include in full all other eligible Tier 1 and Tier 2 capital instruments issued by consolidated subsidiaries in the ADI's Level 2 capital if all the criteria for inclusion have been met, unless APRA specifically requires them to be excluded. APRA may exclude a capital instrument if it assesses that the instrument does not, in substance, represent a genuine contribution to the financial strength of the ADI. This might be, for instance, where the instrument has been funded (directly or indirectly) or guaranteed by another member of the Level 2 group.

APRA proposes to adopt the Basel III approach to limit the recognition of minority interests associated with common shares and Additional Tier 1 and Tier 2 capital instruments of consolidated subsidiaries held by third parties. The allowable amount would be calculated in accordance with the approach set out in Appendix 5.

2.1.5 Criteria for inclusion in consolidated capital – capital issues involving use of special purpose vehicles (SPVs)

Under Basel III, capital instruments issued to third parties out of SPVs cannot be included in Common Equity Tier 1. This is consistent with APRA's current requirements for Fundamental Tier 1 capital.

Basel III permits recognition of Additional Tier 1 and Tier 2 capital instruments issued to third parties through an SPV subject to the conditions that:

- the instruments (between the ADI and the SPV and between the SPV and investors) fully meet the relevant entry criteria for the level of capital;
- the only asset of the SPV is its investment in the capital of the ADI; and
- issue proceeds are readily accessible to an operating entity or the holding company within the consolidated group.

These conditions are essentially included in APRA's current requirements, set out in Attachment C of APS 111. However, some amendments will be required to Attachment C to align APRA's requirements with those of Basel III in relation to, for instance, the new entry criteria for each level of capital.

2.2 Loss absorbency of regulatory capital at the point of non-viability

During the global financial crisis, a number of distressed international banks were rescued by the injection of public sector funds in the form of common equity and other forms of Tier 1 capital. This had the effect of supporting not only depositors but also investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases Additional Tier 1 instruments, did not absorb losses incurred by banks that would have failed had the public sector not provided support.

In response to this outcome, the Basel III reforms require that all regulatory capital instruments (i.e. all Additional Tier 1 and Tier 2 instruments) must be capable of bearing loss. In particular, a public sector injection of capital needed to avoid the failure of an ADI should not protect investors in regulatory capital instruments from incurring the loss that they would have suffered had the public sector not chosen to intervene. To achieve this objective, the criteria for inclusion in regulatory capital have been enhanced to ensure that all regulatory capital instruments issued by ADIs are capable of absorbing losses in the event that an ADI is unable to support itself in the market place.

2.2.1 Application

APRA proposes that the Basel III non-viability requirements outlined below will be required to be included in the terms of all Additional Tier 1 and Tier 2 instruments (with additional requirements for ADIs operating as part of wider consolidated groups – see section 2.2.3). APRA proposes that these requirements must be incorporated in the contractual terms and conditions of each instrument eligible as regulatory capital from 1 January 2013. (Section 7.2.3 outlines the treatment of instruments that do not meet the eligibility criteria for regulatory capital after 1 January 2013).

2.2.2 Non-viability requirements

Write-off as default provision

Basel III requires that the terms and conditions of all Additional Tier 1 and Tier 2 instruments issued by ADIs provide for such instruments to be either written-off or converted into common equity upon the occurrence of a trigger event. APRA proposes that all Additional Tier 1 and Tier 2 instruments must contain a default provision that the instrument will be fully written-off upon the occurrence of a trigger event. As an alternative, but only with APRA approval at the time of issue, ADIs may instead elect to include a provision providing for conversion of the instrument into common equity upon the occurrence of a trigger event. Conversion cannot be into unlisted equity.

Trigger event

APRA is proposing to adopt the Basel III definition of a trigger event. That is, a capital instrument will be written off or converted into listed equity at the earlier of:

- a decision that a write-off (or, where applicable, conversion), without which the ADI would become non-viable, is necessary, as determined by APRA; and
- the decision to make a public sector injection of capital, or equivalent support, without which the institution would have become non-viable, as determined by APRA.

Conversion

Under APRA's current requirements, capital instruments converting into ordinary shares must include a maximum conversion ratio, which is set based on 50 per cent of the ordinary share price at the time of issue. The Basel III proposals do not provide for an explicit conversion limit; however, APRA remains of the view that a limit is necessary to enable an ADI to readily quantify the maximum dilution and to ensure that it has prior shareholder approval for any future issue of the required number of shares. APRA proposes to replace the current maximum conversion ratio based on 50 per cent of the ordinary share price at the time of issue with one based on 20 per cent of the ordinary share price at the time of issue. Where instruments are to convert to common equity, APRA proposes that ADIs will be required to maintain all prior authorisations necessary to immediately issue the relevant number of shares to effect conversion, as specified in the instrument's terms and conditions, should the trigger event occur.

2.2.3 Group treatment

APRA proposes that, where an issuing ADI is a subsidiary of a wider banking group regulated by APRA and the ADI or its parent wishes the instrument to be included in the capital of the consolidated Level 2 group, the terms and conditions must specify a write-off or conversion event that can be triggered by APRA. This additional trigger event is the decision to make a public sector injection of capital, or equivalent support, in the APRA-regulated ADI or its parent, without which the ADI or its parent would have become nonviable, as determined by APRA.

Furthermore:

- if the instrument converts into common shares, conversion must be into the common shares of a listed parent institution; and
- any supervisor of the subsidiary must not be able to impede APRA's right to trigger conversion or write-off of the instrument.

Where the APRA-regulated ADI is a subsidiary of another institution that is not regulated by APRA, if the instrument is to be recognised as capital under APRA's prudential requirements it must, in addition to the conversion trigger event required above, provide that:

- any supervisor of the parent entity cannot impede APRA's right to require write-off or conversion in relation to the APRA-regulated institution; and
- any right of write-off or conversion by the parent supervisor must generate Common Equity Tier 1 in the Australian institution and must not lead to the issuance of unlisted equity by the Australian institution.

Chapter 3 – Regulatory adjustments to capital

Under Basel III, a number of regulatory adjustments are applied to regulatory capital – in most cases, to Common Equity Tier 1. Basel III also provides discretion to apply a 'threshold treatment' to give limited recognition to certain items in Common Equity Tier 1. In addition, Basel III applies a risk-weight at 1250 per cent to certain exposures that were previously 50:50 deductions from Tier 1 and Tier 2 under the Basel II Framework.

3.1 Adjustments to Common Equity Tier 1

Basel III requires the following to be deducted in full from Common Equity Tier 1:

- goodwill and other intangibles;[15]
- deferred tax assets other than deferred tax assets that arise from 'temporary' (timing) differences;
- cash flow hedge reserve;
- shortfall of the stock of provisions to expected losses;[16]
- gain on sale related to securitisation transactions;
- cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities;
- defined benefit pension fund assets;
- investments in own shares (treasury stock); and
- reciprocal cross holdings in the capital of banking, financial and insurance entities.

APRA's current approach in APS 111 requires the deduction of many of the items listed above. However, some amendments to APS 111 will be required to align APRA's requirements fully with Basel III. These amendments are outlined below.

3.1.1 Deductions already included in APS 111

APRA proposes to adopt the Basel III principle that regulatory deductions should be made from Common Equity Tier 1. The rationale is that, if an element of the balance sheet is of insufficient quality to be included in the calculation of regulatory capital, then it is not appropriate for it to be included in Common Equity Tier 1. APRA proposes that the following deductions currently required from Tier 1 capital under APS 111 will be required to be made from Common Equity Tier 1:

- goodwill and other intangibles;
- deferred tax assets;[17]
- cash flow hedge reserve;
- shortfall of the stock of provisions to expected losses (for advanced ADIs);
- gain on sale related to securitisation transactions;
- cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities;
- defined benefit pension fund surpluses; and
- all holdings of the capital of banking, financial and insurance entities.

APRA's definition of 'intangibles' includes capitalised expenses and capitalised transactions costs (see APS 111 Attachment D, paragraphs 9 and 10). APRA is not proposing to change this definition.

15 The deduction of mortgage servicing rights is subject to the threshold treatment.

16 For ADIs approved to use advanced IRB approaches to credit risk.

17 Including for timing differences, as discussed in section 3.2.1.

3.1.2 Differences between Basel III deductions and APS 111

For some other items, the adjustments to regulatory capital in APS 111 are different in certain elements from Basel III. For the reasons set out below, APRA proposes to maintain the difference in approach with respect to certain elements of:

- investments in own shares (treasury stock); and
- investments in the capital of banking, financial and insurance institutions that are outside the scope of regulatory consolidation.

Investments in own shares

Basel III requires an ADI to deduct investments in its own common shares, Additional Tier 1 and Tier 2 capital from the corresponding tier of capital, to avoid the double-counting of the ADI's own capital. It also requires deduction of any instruments that an ADI could be contractually obliged to purchase. The deduction applies to investments in the banking and trading book. Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk. Further, Basel III requires deduction of exposures to own shares through holdings of index securities. APRA invites submissions on the practical consequences of a lookthrough approach to index securities.

APS 111 currently requires ADIs to deduct (from the appropriate tier of capital) all holdings of their own capital instruments, unless exempted by APRA. Hence, APRA's approach is broadly in line with Basel III. However, it differs in two particular respects. Firstly, APS 111 also requires deduction from capital of any unused trading limit in own capital instruments agreed with APRA. Secondly, for holdings of capital instruments by other group members, APS 111 allows inclusion in capital of two types of holding: those funded by third-party investors (such as life insurance policyholders) and those included in employee share-based remuneration schemes. APRA is of the view that these holdings are in effect third-party investments and do not conflict with the Basel III objective of avoiding the double-counting of capital. APRA does not therefore propose to remove these exemptions.

Investments in the capital of banking, financial and insurance institutions that are outside the scope of regulatory consolidation

Under Basel III, investments in banking, financial and insurance institutions that are outside the scope of regulatory consolidation (non-consolidated financial institutions) include:

- direct, indirect and synthetic holdings of capital instruments. ADIs should look through holdings of index securities to determine their underlying holdings of capital;
- holdings in both the banking book and trading book; and
- underwriting positions held for more than five working days.

If the capital instrument does not meet the criteria for regulatory capital of the ADI, the capital is to be considered common shares for deduction purposes. In the case of index securities, national authorities may permit ADIs to use a conservative estimate if ADIs find it operationally burdensome to look through and monitor their exact exposures to the capital of other financial institutions.

The Basel III treatment of these investments depends on their size and their nature. In particular, Basel III distinguishes between investments on the basis of significance. 'Significant investments' are defined as investments that are more than 10 per cent of the issued common share capital of the non-consolidated financial institution.

Under Basel III, **significant investments** in non-consolidated financial institutions that are not common shares must be fully deducted from capital, using a 'corresponding deduction approach'. This means that the deduction is applied to the same tier of capital for which the capital would qualify if it were issued by the ADI itself. Where deduction is required from a particular tier of capital but the ADI does not have enough of that tier to satisfy the requirement, the shortfall will be deducted from the next higher tier of capital.

Significant investments in the common shares of non-consolidated financial institutions are subject to the threshold treatment described in section 3.2 below.

Under Basel III, **insignificant investments** in non-consolidated financial institutions that in aggregate exceed 10 per cent of the ADI's common equity must be deducted from capital, using the corresponding deduction approach. Amounts below 10 per cent, which are not deducted, will continue to be risk-weighted in accordance with the prudential requirements for credit risk (for investments in the banking book) or market risk (for trading book investments).

APRA's current requirements do not make the Basel III distinction between significant and insignificant investments in non-consolidated financial institutions but at Level 1 and Level 2, they do require deduction (50 per cent from Tier 1 and 50 per cent from Tier 2 capital)[18] for:

- all investments in other ADIs' capital instruments, unless held for trading purposes;[19]
- investments in capital instruments of non-consolidated subsidiaries whether regulated or unregulated;
- significant minority investments (being between 20 and 50 per cent of voting shares) in other financial institutions, including insurers;[20] and
- investments in capital instruments of non-consolidated financial institutions, including equity holdings under 20 per cent, in respect of the excess of any individual investment above 0.15 per cent of the ADI's capital base (at Level 2) or the excess of the aggregate of individual investments (including equity held in commercial enterprises) below 0.15 per cent of the ADI's capital base that is above five per cent of the ADI's capital base, before deductions.

Individual investments below those limits are risk-weighted at 300 per cent (if listed) or 400 per cent (if unlisted).

18 As provided under the Basel II Framework.

19 Unless the subsidiary acts as a holding company for pass-through of exposures and other capital investments in subsidiary ADIs or equivalent overseas deposit-taking institutions. Holdings by a subsidiary holding company in subsidiaries not eligible for consolidation must be deducted net of the value of the holding company's investment in any consolidated subsidiary ADI or equivalent overseas deposit-taking institution.

20 For investments of more than 50 per cent, intangibles, post-acquisition profits and reserves are deducted from Tier 1 while net tangible assets are deducted 50:50 from Tier 1 and Tier 2 capital. For investments in insurers, value of business in force (VBIF) must be deduced from Tier 1.

The rationale for APRA's longstanding requirement to deduct investments in non-consolidated financial institutions is to avoid the double-counting of capital in the financial system and to address the heightened systemic risk posed by such cross-holdings.[21] Capital cannot be used more than once, and APRA's deductions rule ensures that when capital absorbs a loss at one financial institution, this does not immediately result in a loss of regulatory capital in an ADI that has invested that capital. Accordingly, APRA does not support allowing any such investments in capital calculations, whether significant or otherwise.

APRA therefore proposes to continue to require full deduction of investments in non-consolidated financial institutions but to replace the current 50:50 deduction from Tier 1 and Tier 2 with the Basel III corresponding deduction approach described above.[22] This deduction would include:

- all investments in non-consolidated financial institutions (as defined in Basel III) in the banking book;
- the net long position (as defined in Basel III)[23] of all investments in non-consolidated financial institutions in the trading book; and
- underwriting positions held for more than five working days.

Consistent with the principle of avoiding double-counting and to simplify capital calculations, APRA proposes to remove the exemptions, described above, currently provided for small individual investments.

21 The Basel Committee's Consultative Document *Strengthening the resilience of the banking sector*, December 2009, paragraph 101 supports this rationale, noting that deduction will 'increase the resilience of the banking sector to financial shocks and reduce system risk and procyclicality'.

22 For Additional Tier 1 instruments held in the banking book, this will be a stricter approach than under Basel III but is a less strict approach for Tier 2 instruments.

23 The net long position is defined as the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year. Refer paragraph 80 of the Basel III text.

ADIs are invited to make submissions as to whether requiring ADIs to look through holdings of index securities to determine their holdings of investments in non-consolidated financial institutions would be operationally burdensome.

Basel III provides national supervisors with the discretion to exclude temporarily investments made in the context of resolving or providing financial assistance to reorganise a distressed financial institution. APRA intends to exercise this discretion in appropriate circumstances.

At Level 1, where other ADIs or APRA-regulated institutions, or their equivalent overseas institutions, are wholly owned or effectively controlled (directly or indirectly) by the ADI and have been consolidated with the ADI at Level 2 for capital adequacy purposes, equity exposures and capital instruments held in such subsidiaries are risk-weighted at 400 per cent in APS 111. APRA proposes to retain this requirement.

3.2 Threshold deductions

Basel III allows limited recognition of three asset items when calculating Common Equity Tier 1. These items are:

- deferred tax assets relating to 'temporary' (timing) differences;
- significant investments in the common shares of non-consolidated financial institutions; and
- mortgage servicing rights.

Supervisors have the discretion to allow recognition of each of these items up to 10 per cent of the ADI's common equity, and up to a total of 15 per cent for the three items in aggregate. Amounts above these limits must be deducted from Common Equity Tier 1; amounts not deducted are to be risk-weighted at 250 per cent.

APRA does not propose to exercise this discretion.

3.2.1 Deferred tax assets for temporary differences

Basel III applies a split treatment for deferred tax assets. Deferred tax assets that rely on the future profitability of the ADI to be realised are to be deducted in the calculation of Common Equity Tier 1 (see section 3.1 above). Deferred tax assets may be netted with associated deferred tax liabilities only if the deferred tax assets and liabilities relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. However, deferred tax assets relating to temporary differences are eligible for the concessional treatment outlined above. Such assets arise from the differences between the carrying amount of an asset and its tax base. For example, an ADI may recognise provisions for potential losses on loans in determining tax amounts and net profits in its published financial statements but the taxation authority may not recognise such provisions until sometime in the future; this deferred tax asset represents the 'early recognition' of potential loan losses.

Under longstanding policy, APRA requires all deferred tax assets (net of deferred tax liabilities) to be deducted from capital. The deduction is from Tier 1 capital, except for deferred tax assets associated with collective provisions eligible for inclusion in the General Reserve for Credit Losses, which are in effect deducted from Tier 2 capital. In Australia, deferred tax assets, whatever their origin, rely on the future profitability of the ADI to be realised and are not available to absorb losses on a gone-concern basis.

APRA is aware that, in some jurisdictions, deferred tax assets do not rely on the future profitability of the banking institution and are, in effect, treated like receivables from the local taxation authority. This is not the case in Australia. APRA is also of the view that prudential capital requirements should be kept separate from a jurisdiction's tax regime.

Hence, APRA retains its view that deferred tax assets cannot be included in the calculation of regulatory capital and it does not intend to allow limited recognition of deferred tax assets for temporary differences. APRA proposes to require all deferred tax assets (net of deferred tax liabilities), including those arising from temporary differences, to be fully deducted from Common Equity Tier 1.

3.2.2 Significant investments in the common shares of non-consolidated financial entities

Basel III requires significant investments in the common shares of non-consolidated financial institutions to be fully deducted from an ADI's capital if these investments exceed 10 per cent of the ADI's common equity. However, amounts below this threshold may receive recognition when calculating Common Equity Tier 1, with a risk-weight of 250 per cent.

As noted in section 3.1 above, APRA's longstanding policy requires all investments in the capital of non-consolidated financial institutions (except for an exemption for small investments) to be deducted from an ADI's capital so as to avoid double-counting in the financial system. APRA sees no prudential basis for distinguishing between investments in common equity and investments in other capital instruments, whether significant or insignificant. Accordingly, it does not propose to exercise its discretion in this area. APRA proposes that all significant investments in non-consolidated financial institutions, whether in the form of common equity or other capital instruments, be deducted from capital, using the corresponding deduction approach described above.

3.2.3 Mortgage servicing rights

Mortgage servicing rights are servicing contracts on a portfolio of mortgage loan receivables. They are contractual agreements, typically between the original lender and a third party specialising in the various functions of servicing mortgages, including collection of mortgage payments and payment of taxes and insurance premiums. They can potentially be on-sold to other parties. Investor interest in mortgage servicing rights is typically driven by the opportunity to earn a spread/margin.

Mortgage servicing rights are not common in Australia. *AASB 138 Intangible Assets* (AASB 138) deems them to be intangible assets and, accordingly, APRA would require these assets to be deducted from Tier 1 capital at both Levels 1 and 2. APRA remains of the view that this is the most appropriate treatment and proposes to require any mortgage servicing rights to be deducted from Common Equity Tier 1, consistent with the treatment of other intangible items under Basel III.

3.3 Other deductions from capital

To simplify the calculation of capital, Basel III changes the treatment of the following items, which were previously deducted 50:50 from Tier 1 and Tier 2 capital and now will be risk-weighted at 1250 per cent:

- certain securitisation exposures;
- non-payment/delivery on non-delivery-versus-payment (DvP) and non-payment-versus-payment (PvP) transactions;
- certain equity exposures under the probability of default (PD)/loss given default (LGD) approach; and
- significant investments in commercial entities.

APRA proposes to adopt the Basel III approach and apply a 1250 per cent risk-weight to those securitisation exposures currently deducted 50:50 in *Prudential Standard APS 120 Securitisation* (APS 120).[24] APRA will also apply a 1250 per cent risk-weight to non-DvP and non-PvP transactions.

APRA did not adopt the PD/LGD approach for equity exposures and does not propose any changes to its current treatment of such exposures.

APRA does not, however, propose applying a 1250 per cent risk-weight to significant investments in commercial institutions. Currently, APRA applies a 50:50 deduction for investments in commercial institutions in excess of:

- 0.15 per cent of the ADI's Level 2 capital base before deductions (at both Tier 1 and Tier 2) for an individual investment; and
- five per cent of the ADI's Level 2 capital base before deductions (at both Tier 1 and Tier 2) in aggregate.

Individual investments below these limits are risk-weighted at 300 per cent (if listed) or 400 percent (if unlisted).

APRA's longstanding position is that the ownership of equity or the holding of other investments in commercial institutions is not a normal part of banking business. Where an ADI undertakes such activity it is APRA's view that the activity should be funded by shareholders, not depositors or other creditors. Consistent with its longstanding position and the proposed treatment of investments in non consolidated financial institutions, APRA proposes to require ADIs to deduct from Common Equity Tier 1:

- all investments in commercial institutions held in the banking book; and

24 Most exposures in APS 120 are deducted 50:50; exceptions requiring deduction from Tier 1 capital include unpaid gains on sale, funds lent to establish reserve accounts, overpayments for assets and capitalised expenses. APRA proposes that these items will be deducted from Common Equity Tier 1 rather than from Tier 1.

- underwriting positions in commercial institutions held for more than five working days.

APRA proposes that investments held in the trading book continue to be treated in accordance with the relevant market risk prudential requirements of *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116).

In addition to the items listed above, APRA currently requires the following items, which are not treated as 50:50 deductions under the Basel II Framework, to be deducted 50:50 under APS 111:

- any guarantee, or credit derivative covering credit exposures at Level 2, that provides for a materiality threshold below which no payment will be made in the event of a loss; and
- any non-repayable loans advanced by an ADI under APRA's certified industry support arrangements.

In light of the changes made under Basel III to existing 50:50 deductions to simplify capital calculations, APRA proposes to deduct these remaining items in full from Common Equity Tier 1.

Chapter 4 – Capital buffers

The Basel III regulatory capital framework introduces two capital buffers aimed at addressing procyclicality and raising the resilience of the banking system. These are:

- a capital conservation buffer; and
- a countercyclical buffer.

The objectives are to build capital buffers in individual ADIs and in the banking system that can be used in times of stress and to achieve the broader macroprudential goal of protecting the banking system from periods of excess credit growth.

4.1 Capital conservation buffer

Basel III introduces a capital conservation buffer of 2.5 per cent, comprised of Common Equity Tier 1, above the regulatory minimum capital requirement. This buffer is intended to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be used to absorb losses during periods of financial and economic stress.

The capital conservation buffer regime imposes constraints on an ADI when its Common Equity Tier 1 level falls within the capital conservation buffer range. The constraints limit distributions such as dividends and bonuses, and the level of constraint increases the closer an ADI's Common Equity Tier 1 level is to the required minimum. The minimum Basel III distribution constraints, based on a 2.5 per cent capital conservation buffer, are shown in the following table. An ADI would be required to conserve 80 per cent of its earnings in the subsequent financial year if its holdings of Common Equity Tier 1 capital were only between 0.625 per cent and 1.25 per cent above its minimum Common Equity Tier 1, Tier 1 and Total Capital requirements. That is, it could not make payouts of more than 20 per cent of its earnings in terms of dividends, share buybacks and discretionary bonus payments.

Table 4.1 – Individual ADI minimum capital conservation requirements (for a buffer of 2.5 per cent)

Capital conservation buffer range (percentage)			Minimum capital conservation ratios (expressed as a percentage of earnings)
0	to	0.625	100
> 0.625	to	1.250	80
> 1.250	to	1.875	60
> 1.875	to	2.500	40
2.500			0

APRA proposes to introduce a capital conservation buffer, comprised of Common Equity Tier 1, of up to 2.5 per cent. The buffer will apply in addition to the minimum Common Equity Tier 1, Additional Tier 1 and Total Capital ratio requirements and will need to be met with Common Equity Tier 1, over and above any Common Equity Tier 1 needed to meet the minimum capital requirements.

Other key aspects of APRA's proposed capital conservation buffer requirements, in line with Basel III, are:

(a) **Elements subject to the restriction on distributions**: Items proposed to be considered as distributions include dividends and share buybacks, discretionary payments on Additional Tier 1 capital instruments and discretionary bonus payments to staff. Payments that do not result in a depletion of Common Equity Tier 1, which may for example include certain scrip dividends and proceeds of any dividend reinvestment, are not considered distributions.

(b) **Definition of earnings:** Earnings are defined as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after the tax that would have been reported had none of the distributable items been paid. As such, any tax impact of making such distributions is reversed out.

(c) **Solo or consolidated application:** The framework is proposed to be applied at the consolidated level, i.e. restrictions would be imposed on distributions out of the consolidated group (Level 2). APRA also proposes to have discretion, in line with the Basel III requirements, to apply the distribution constraints at Level 1 to conserve resources in specific parts of the group.

(d) **Additional supervisory discretion:** Although the buffer is capable of being drawn down when needed, ADIs would not be expected to operate in the buffer range in normal times. APRA therefore proposes that an ADI operating within the buffer range be required to enter into a capital remediation plan within a timeframe determined by APRA. In any case, the Internal Capital Adequacy Assessment Process (ICAAP) of ADIs will require their capital management plans to demonstrate how they will rebuild buffers over an appropriate timeframe.[25]

Notwithstanding these requirements, APRA also proposes to continue the approach to dividend and interest payments on Tier 1 instruments in APS 111 paragraph 30. That is, unless otherwise approved by APRA, the aggregate amount of dividend or interest payments cannot exceed, at Level 1 and Level 2, an ADI's after-tax earnings.

25 APS 110, paragraph 6(b).

4.2 Relationship of the buffer to APRA's Prudential Capital Requirements

Under the Basel II Framework, the supervisory review process (known as Pillar 2) is intended to ensure that ADIs have adequate capital to support all the risks in their business and to encourage ADIs to develop and use better risk management techniques in monitoring and managing their risks. Based on this process, APRA sets a PCR for Tier 1 and Total Capital for each ADI, which must be met at all times.[26] The PCR is set at a level proportional to each ADI's overall risk profile.

This approach will not change under the proposed Basel III reforms. However, given the focus of Basel III on Common Equity Tier 1 as the highest quality component of capital, APRA believes that it is appropriate to set a PCR primarily by reference to Common Equity Tier 1. PCRs would also be set for Tier I and Total Capital.

APRA proposes to apply the capital conservation buffer above the PCR for Common Equity Tier 1 determined for each ADI.[27] However, where APRA applies a PCR for Common Equity Tier 1 above 4.5 per cent, APRA will have regard to the cumulative impact of the PCR and the capital conservation buffer, and may choose to set the capital conservation buffer at a level below 2.5 per cent. In such a case, the buffer would be divided into four equal ranges for the application of the minimum capital conservation ranges. In no case, however, would the sum of the PCR for Common Equity Tier 1 plus the capital conservation buffer be less than seven per cent.

26 Refer APRA's Discussion Paper 'Implementation of the Basel II Capital Framework: 10 Supervisory Review Process', 12 September 2007, at www.apra.gov.au/adi/Documents/Discussion-paper-Supervisory-Review-Process.pdf.

27 For the purposes of this discussion paper, the discussion will focus on a Common Equity Tier 1 PCR only. APRA proposes to also apply the principles outlined in this section to a Tier 1 PCR and Total Capital PCR.

The diagrams in Figures 4.1 and 4.2 illustrate two different scenarios for the PCR and the capital conservation buffer:

- a PCR for Common Equity Tier 1 (CET1) of 4.5 per cent and a capital conservation buffer (CCB) of 2.5 per cent (Figure 4.1); and
- a PCR for Common Equity Tier 1 (CET1) of 5.5 per cent and a capital conservation buffer (CCB) of 2.0 per cent (Figure 4.2).

APRA notes that, in view of the significant increases in minimum capital requirements under Basel III, the existing PCRs determined for each ADI will need to be reviewed and recalibrated. This will occur once the minimum capital requirements are finalised. ADIs will be informed of changes to their PCRs before the commencement of the Basel III capital regime. APRA's current policy of prohibiting the disclosure of PCRs will continue.

Figure 4.1 – Application of the PCR and capital conservation buffer: Scenario 1

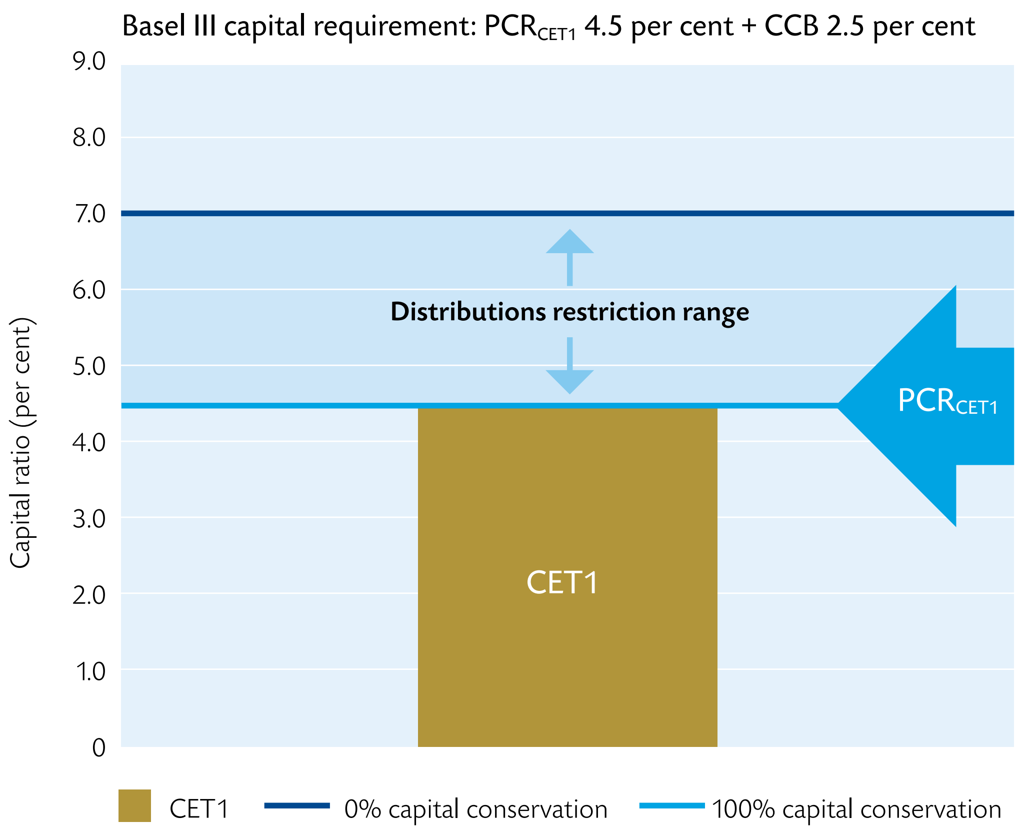
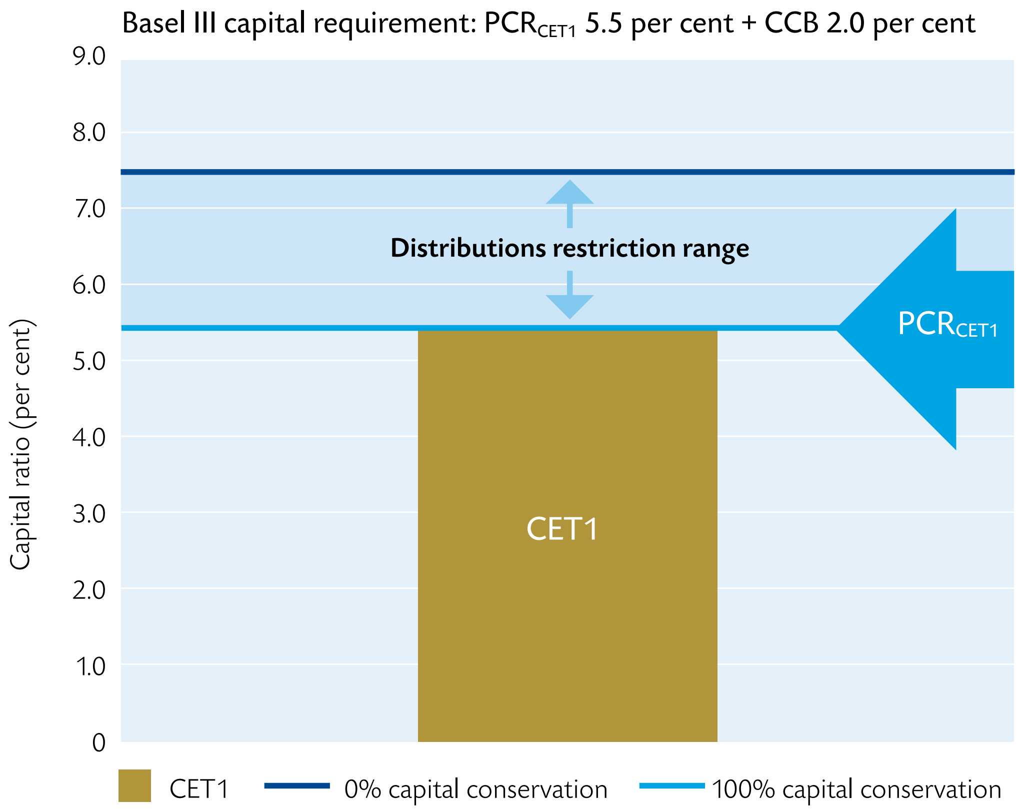


Figure 4.2 – Application of the PCR and capital conservation buffer: Scenario 2



4.3 Countercyclical buffer

Basel III also introduces a countercyclical buffer, which aims to ensure that banking system capital requirements take account of the macro-financial environment in which banking institutions operate. It will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk and is intended to ensure the banking system has an additional buffer of capital to protect it against future potential losses. This focus on excess aggregate credit growth means that jurisdictions are likely to only need to deploy the buffer on an infrequent basis.

The countercyclical buffer varies between zero and 2.5 per cent of total risk-weighted assets and will be implemented through an extension of the capital conservation buffer. The countercyclical buffer is to be met with Common Equity Tier 1 only, although the Basel Committee is still reviewing the question of permitting other fully loss-absorbing capital.

APRA proposes to introduce the Basel III countercyclical buffer in its prudential capital regime. Broadly speaking, the application of the buffer would have the following main elements:

- APRA will continuously review the need for the countercyclical buffer, in consultation with the Reserve Bank of Australia (RBA);
- in addition to macroeconomic indicators of excessive credit growth such as the credit-to-gross domestic product (GDP) gap[28], APRA's review will be informed by input from the supervisory visits it conducts;
- any countercyclical buffer will be applied by extending the range of the capital conservation buffer. As an example, a one per cent countercyclical buffer added to a capital conservation buffer of 2.5 per cent would lead to a combined buffer of 3.5 per cent; and
- the imposition of the countercyclical buffer will be publicly announced, and would apply to the Australian exposures of locally incorporated ADIs. To give ADIs time to adjust, APRA will announce any decision to raise the level of the capital conservation buffer to include a countercyclical buffer at least 12 months ahead of the effective date from which it will apply.

The countercyclical buffer is subject to jurisdictional reciprocity with respect to internationally active ADIs. Jurisdictional reciprocity means that host authorities take the lead in setting buffer requirements that would apply to credit exposures held by institutions located in their jurisdiction. They would also be expected to promptly inform their foreign counterparts of decisions to apply the countercyclical buffer so that those counterparts can require their banks to apply the buffer to their group institutions.

Home authorities will be responsible for ensuring that the banks they supervise correctly calculate their buffer requirements based on the geographic location of their branch exposures. The home authorities will be able to require that the banks they supervise maintain higher buffers if they judge the host authorities' buffer to be insufficient.

Therefore, the countercyclical buffer is intended to apply to the Australian exposures of foreign ADIs operating in Australia as branches where those foreign ADIs are subject to offshore regimes that have introduced a countercyclical buffer regime.

APRA notes that, where potentially unsound growth in credit exposures is evident, it will continue its current practice of identifying less prudent lending practices and taking appropriate supervisory steps, such as supervisory feedback to the relevant boards and increasing the PCRs of ADIs undertaking excessive credit growth.

28 Refer to Basel Committee's *Guidance for national authorities operating the counter-cyclical buffer,* December 2010: www.bis.org/publ/bcbs187.htm.

Chapter 5 – Leverage ratio

The Basel Committee identified that one of the underlying features of the global financial crisis was the build-up of excessive on- and off-balance sheet leverage in the global banking system, despite the fact that many banks still showed strong risk-based capital ratios. During the most severe part of the crisis, the market forced the banking system to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital and contraction in credit availability.

To address this, Basel III introduces a simple, transparent, non-risk based leverage ratio that is calibrated to act as a supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

- constrain the build-up of leverage in the banking system, helping to avoid a destabilising deleveraging process that can damage the financial system and the economy; and
- reinforce the risk-based requirements with a simple 'backstop' measure that provides additional safeguards against model risk and measurement error.

APRA proposes to introduce the Basel III leverage ratio in its prudential capital regime.

5.1 Calculating the leverage ratio

The basis of calculation for the leverage ratio is the average of the monthly leverage ratio over each quarter based on the following definitions of capital (the capital measure) and total exposure (the exposure measure).

As currently proposed, the capital measure for the leverage ratio will be based on the new Basel III definition of Tier 1 capital. The Basel Committee will also collect data to track the impact of using total regulatory capital and Common Equity Tier 1. Items that are fully deducted from capital do not contribute to leverage and will therefore also be deducted from the measure of exposure.

The exposure measure for the leverage ratio is intended to follow the accounting measure of exposure. To be measured consistently with financial accounts:

- on-balance sheet, non-derivative exposures are net of specific provisions and valuation adjustments (e.g. credit valuation adjustments);
- physical or financial collateral, guarantees or credit risk mitigation purchased is not allowed to reduce on-balance sheet exposures; and
- netting of loans and deposits is not allowed.

5.2 Transitional arrangements

Basel III provides for a long transitional period for the leverage ratio, comprising a supervisory monitoring period that commenced on 1 January 2011 and a parallel run period from 1 January 2013 to 1 January 2017. During the parallel run period, a minimum Tier 1 leverage ratio of three per cent will be tested and the leverage ratio and its components, including its behaviour relative to the risk-based requirement, will be monitored. Full disclosure of the leverage ratio and its components will commence on 1 January 2015.

Based on the results of the parallel run period, the Basel Committee will make any final adjustments to the definition and calibration of the leverage ratio in the first half of 2017, with a view to migrating the leverage ratio to a Pillar 1 requirement on 1 January 2018.

APRA proposes to apply these transitional arrangements.

Chapter 6 – Prudential disclosure

To improve the transparency of regulatory capital and market discipline, Basel III provides for the public disclosure of the following items:

- a full reconciliation of regulatory capital elements back to the balance sheet in the audited financial statements;
- separate disclosure of all regulatory adjustments;
- a description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply; and
- a description of the main features of capital instruments issued.

In addition to these enhanced transparency requirements, Basel III also requires ADIs to make available on their websites the full terms and conditions of all instruments included in regulatory capital. Entities that disclose alternative ratios involving components of regulatory capital (e.g. 'Equity Tier 1', 'Core Tier 1' or 'Tangible Common Equity' ratios) will be required to accompany these with a comprehensive explanation of how these ratios are calculated.

The Basel Committee will issue more detailed Pillar 3 disclosure requirements in 2011. When these are released, APRA will consult on the detailed amendments to be made to *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (APS 330). The existing requirement for the main features of capital instruments to be easily understood and publically disclosed under APS 330 will be retained.

Chapter 7 – Transitional arrangements

The Basel Committee has set out detailed transitional arrangements for implementing the Basel III capital requirements. This is to help ensure that the global banking system can meet the higher capital requirements through reasonable earnings retention and capital raising, while still supporting lending to the economy. ADIs in Australia are well placed to meet the new requirements and APRA therefore proposes to accelerate the transition timetable in some areas.

7.1 Overview of Basel III transitional arrangements

The Basel Committee transitional arrangements are outlined in Table 7.1 below. It shows that, as of 1 January 2013, ADIs will need to meet the following requirements, which phase-in the new global minimum requirements set out in section 2.1 above:

- a 3.5 per cent Common Equity Tier 1 ratio;
- a 4.5 per cent Tier 1 capital ratio; and
- an 8.0 per cent Total Capital ratio.

These ratios are all measured in relation to risk-weighted assets.

Table 7.1 – Basel Committee's phase-in arrangements

At 1 January	2013	2014	2015	2016	2017	2018	2019
	Per cent						
Min CET1	3.5	4.0	4.5	4.5	4.5	4.5	4.5
(2) Capital Conservation Buffer				0.625	1.25	1.875	2.5
(3) Min CET1 + Conservation Buffer	3.5	4.0	4.5	5.125	5.75	6.375	7.0
(4) Phase in of deductions from CET1		20	40	60	80	100	100
(5) Min T1	4.5	5.5	6.0	6.0	6.0	6.0	6.0
(6) Min T1 + Conservation buffer				6.625	7.25	7.875	8.5
(7) Min Total Capital	8.0	8.0	8.0	8.0	8.0	8.0	8.0
(8) Min Total + Conservation Buffer	8.0	8.0	8.0	8.625	9.25	9.875	10.5
(9) Instruments that no longer qualify as T1 or T2	Phased out over 10 year horizon beginning 2013 Recognition capped at 90 per cent from 1 January 2013, cap reducing by 10 per cent each year, ending 2023						
(10) Countercyclical Buffer	Up to an additional 2.5 per cent CET1 from 1 January 2016						
(11) Leverage ratio	Supervisory monitoring from 2011 Parallel run 2013 – 2017 Disclosure from 2015 Migration to Pillar 1 2018						

7.2 Basel III transition in Australia

7.2.1 Minimum capital ratios

Based on the results of the most recent quantitative impact study (QIS) information submitted to APRA by a number of the larger ADIs and APRA's analysis of current capital ratios for other ADIs, APRA expects ADIs will be well placed to meet the new global minimum capital requirements, without the need for any phasing-in. Accordingly, APRA proposes that, from 1 January 2013, all ADIs will be required to meet the following minimum requirements:

- a 4.5 per cent Common Equity Tier 1 ratio;
- a 6.0 per cent Tier 1 capital ratio; and
- an 8.0 per cent Total Capital ratio .

In meeting these minima, ADIs will also need to meet their individual PCRs as determined by APRA, which include any Pillar 2 supervisory adjustments.

Basel III provides transition for the treatment of capital issued out of subsidiaries and held by third parties (e.g. minority interest). APRA does not consider such transition necessary. Accordingly, such capital that is not eligible for inclusion in one of the three components of capital on 1 January 2013 will be excluded from the determination of regulatory capital from that date.

7.2.2 Regulatory adjustments

The Basel Committee has also allowed for the Basel III changes in the approach to deductions and other adjustments to capital to be phased-in over a five-year period. Under APS 111, ADIs have been applying many of the Basel III regulatory deductions for some time. Accordingly, APRA does not believe that the phase-in arrangements are necessary in Australia. APRA proposes to require ADIs to implement the revised regulatory adjustments in full from 1 January 2013.

7.2.3 Outstanding capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital

A number of ADIs have issued non-common equity instruments that currently qualify as Tier 1 or Tier 2 capital. Few, if any, of these instruments will meet all the requirements for inclusion in regulatory capital treatment under Basel III.

APRA has previously confirmed that capital instruments issued prior to the announcement of the Basel III framework will be eligible for transitional treatment beyond 2013.[29] On 27 May 2011, APRA issued a letter to all locally-incorporated ADIs outlining interim arrangements for Additional Tier 1 capital instruments. APRA confirms that, until the end of 2012, eligible Tier 1 capital instruments must continue to satisfy all relevant criteria contained in APS 111. In addition, APRA confirms that it is prepared, on an interim basis, to accept newly issued capital instruments as being eligible for transitional treatment as Additional Tier 1 capital under the Basel III framework, on the basis that they meet the current eligibility requirements in APS 111 and the criteria set out in the Attachment to that letter.[30]

Under the phase-out arrangements, recognition of capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be capped at 90 per cent from 1 January 2013, with the caps reducing by 10 percentage points in each subsequent year.

29 Refer Letters to ADIs dated 18 December 2009, 14 January 2010, 17 September 2010 and 27 May 2011 found at www.apra.gov.au/adi/Publications/Pages/other-information-for-adis.aspx.

30 www.apra.gov.au/adi/Publications/Documents/Basel-III-interim-Tier-1-criteria_FINAL.pdf.

APRA proposes to adopt the Basel III phase-out arrangements for all noncomplying instruments. Outstanding noncomplying instruments will be required to be phased-out no later than their first available call date, where one exists. ADIs will be required to notify APRA before 1 January 2013, in writing, of the nominal amount of all such instruments outstanding on 1 January 2013 and the first available call date for such instruments. APRA expects ADIs to replace this capital with fully complying instruments and to have effective capital management plans for this purpose.

7.2.4 Capital conservation buffer and countercyclical buffer

The Basel III timetable allows for the capital conservation buffer to be phased-in from 1 January 2016 and become fully effective on 1 January 2019.

APRA is of the view that, taking into account the transition allowance for capital instruments that no longer qualify as Tier 1 and Tier 2, ADIs should be able to meet the minimum Basel III requirement of a Common Equity Tier 1 ratio (including the capital conservation buffer) of seven per cent by 1 January 2016. APRA therefore proposes to implement the capital conservation buffer in full from that date. All ADIs are encouraged to maintain prudent earnings retention policies with a view to meeting the capital conservation buffer as soon as reasonably possible.

Under Basel III, APRA is required to pre-announce its decision to put in place any countercyclical buffer and the level of that buffer by up to 12 months. APRA will, therefore, indicate in 2015 whether any countercyclical buffer will apply from 1 January 2016 and whether any phasing-in of that buffer is necessary.

Table 7.2 – Basel III transition in Australia

At 1 January	2013	2014	2015	2016	2017	2018	2019
	Per cent						
Min CET1	4.5	4.5	4.5	4.5	4.5	4.5	4.5
(2) Capital Conservation Buffer				2.5*	2.5	2.5	2.5
(3) Min CET1 + Conservation Buffer	4.5	4.5	4.5	7.0	7.0	7.0	7.0
(4) Phase in of deductions from CET1	100	100	100	100	100	100	100
(5) Min T1	6.0	6.0	6.0	6.0	6.0	6.0	6.0
(6) Min T1 + Conservation buffer				8.5	8.5	8.5	8.5
(7) Min Total Capital	8.0	8.0	8.0	8.0	8.0	8.0	8.0
(8) Min Total + Conservation Buffer	8.0	8.0	8.0	10.5	10.5	10.5	10.5
(9) Instruments that no longer qualify as T1 or T2	Phased out over 10 year horizon beginning 2013 with recognition capped at 90 per cent in 2013, the caps reducing by 10 per cent each year, ending in 2023 or at first available redemption date.						
(10) Countercyclical Buffer	Up to an additional 2.5 per cent CET1 from 1 January 2016.						
(11) Leverage ratio	Supervisory monitoring from 2011 Parallel run 2013 – 2017 Disclosure from 2015 Migration to Pillar 1 2018						

* This is the capped capital conservation buffer amount.

Chapter 8 – Request for cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties on the financial impact of the proposed Basel III capital reforms and any other substantive costs associated with the proposed reforms. These costs could include the impact on balance sheets, profit and loss, and capital.

As part of the consultation process, APRA also requests respondents to provide an assessment of the compliance impact of the proposed changes. Given that APRA's proposed requirements may impose some compliance and implementation costs, respondents may also indicate whether there are any other regulations relating to ADI capital adequacy that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input to the BCC as well as the final result. The BCC can be accessed at www.finance.gov.au/obpr/bcc/index.html.

Appendix 1 – Criteria for classification as common shares for regulatory capital purposes

1. Represents the most subordinated claim in liquidation of the ADI.
2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
4. The ADI does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled and the statutory or contractual terms do not provide any feature which might give rise to such an expectation.
5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that an ADI is unable to pay distributions that exceed the level of distributable items).
6. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.
7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur.[31] Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.
9. The paid-in amount is recognised as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.
10. The paid-in amount is classified as equity under the relevant accounting standards.
11. It is directly issued and paid-in and the ADI cannot directly or indirectly have funded the purchase of the instrument.
12. The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity[32] or subject to any other arrangement that legally or economically enhances the seniority of the claim.
13. It is only issued with the approval of the owners of the issuing ADI, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.
14. It is clearly and separately disclosed on the ADI's balance sheet.

31 In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares.

32 A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.

Appendix 2 – Unrealised gains and losses – additional reporting

As outlined in Chapter 2.1.1, APRA proposes to adopt the Basel III definition of 'accumulated other comprehensive income and other disclosed reserves' and allow all unrealised gains and losses to be included in determining Common Equity Tier 1. This will be subject to ADIs meeting the requirements in APS 111 on the recognition of fair values, and to additional reporting requirements.

Specifically, six months prior to the adoption date of AASB 9[33], APRA proposes that ADIs will be required to notify it, in writing, of the following:

- the actual amortised cost and fair value balances for loans and deposits (under the previous standard *AASB 139 Financial Instruments: Recognition and Measurement* (AASB 139))[34] and those balances restated, approximately, for any planned reclassifications from amortised cost to fair value under AASB 9; and
- material reclassifications of other financial assets and liabilities from amortised cost to fair value as a result of the adoption of AASB 9.

After the adoption of AASB 9, APRA proposes that ADIs will be required to notify it whenever there is a material reclassification of financial assets and liabilities from amortised cost to fair value. APRA's view is that loans and conventional banking business more generally should be measured at amortised cost. APRA reserves the right to make capital adjustments (among other things) where it considers that an ADI's policies and procedures for the use of fair values do not comply with APRA's prudential requirements and, in particular, are not reliable or affect adversely the ADI's safety and soundness.[35]

Fair value practices

APRA also proposes to require additional reporting from that required by IFRS 13 disclosures.[36] Reporting will be required quarterly for financial assets and liabilities. The proposed reports will capture cumulative, gross unrealised gains and losses recognised on the Statement of Financial Position[37] for fair values that are valued using 'Level 3' (i.e. unobservable) inputs[38], and detailed information about Level 3 inputs.

APRA acknowledges that fair value accounting using Level 3 inputs may be necessary for assets and liabilities associated with complex products where extant markets have temporarily or permanently disappeared. However, APRA considers that there are few, if any, cases where ADIs should enter new business requiring fair value accounting using level 3 valuation methods. APRA invites submissions from ADIs or other parties giving examples of where Level 3 valuation methods may be necessary.

APRA's view is that financial asset and liability valuations using Level 3 inputs are difficult to verify and should be minimal within APRA-regulated institutions. As stated above, APRA may increase an ADI's capital requirements where more than a minimal proportion of an ADI's capital is sourced from revaluations undertaken using Level 3 inputs.

APRA also recognises that some Level 2 valuations may involve more complex products and valuation processes that include some use of unobservable inputs. APRA welcomes submissions on reporting of Level 2 valuations and the recognition of Level 2 valuation practices given the spread of valuation approaches that could be applied. APRA will also consider extending its proposed reports to capture fair value valuations based on Level 2 inputs.[39]

33 AASB 9 is scheduled to come into effect for annual reporting periods beginning on or after 1 January 2015.

34 *AASB 139 Financial Instruments: Recognition and Measurement*

35 The revised version of APS 111 that will take effect from 1 January 2012, states 'Where APRA considers that an ADI's policies and procedures for the use of fair values are not reliable or affect adversely its safety and soundness, APRA may, in writing, require an ADI to amend its policies and procedures, to make adjustments to fair values of financial instruments included in the measurement of capital adequacy (refer Attachment E), to discontinue use of fair value measures for regulatory reporting, or to hold higher levels of capital' (paragraph 55).

36 IFRS 13 is effective for annual reporting periods beginning on or after 1 January 2013.

37 This will involve greater disclosure than required under IFRS 13, which only requires net gains or losses at the end of the reporting period included in profit and loss.

38 IFRS 13 defines Level 3 inputs as unobservable inputs for the asset or liability.

39 IFRS 13 defines Level 2 inputs as inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Appendix 3 – Criteria for inclusion in Additional Tier 1 capital

1. Issued and paid-in.
2. Subordinated to depositors, general creditors and subordinated debt of the ADI.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the ADI's creditors.
4. Is perpetual (i.e. there is no maturity date and there are no step-ups or other incentives to redeem).
5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option an ADI must receive prior supervisory approval; and
   (b) an ADI must not do anything which creates an expectation that the call will be exercised; and
   (c) an ADI must not exercise a call unless:
      (i) it replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the ADI;[40] or
      (ii) the ADI demonstrates that its capital position is well above its PCR after the call option is exercised.
6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and ADIs should not assume or create market expectations that supervisory approval will be given.
7. Dividend/coupon discretion:
   (a) the ADI must have full discretion at all times to cancel distributions/payments;[41]
   (b) cancellation of discretionary payments must not be an event of default;
   (c) ADIs must have full access to cancelled payments to meet obligations as they fall due; and
   (d) cancellation of distributions/payments must not impose restrictions on the ADI except in relation to distributions to common stockholders.
8. Dividends/coupons must be paid out of distributable items.
9. The instrument cannot have a credit sensitive dividend feature (i.e. a dividend/coupon that is reset periodically based in whole or in part on the ADI's credit standing).
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
    (a) reduce the claim of the instrument in liquidation;
    (b) reduce the amount re-paid when a call is exercised; and
    (c) partially or fully reduce coupon/dividend payments on the instrument.

40 Replacement issues can be concurrent with but not after the instrument is called.

41 A consequence of full discretion at all times to cancel distributions/payments is that 'dividend pushers' are prohibited. An instrument with a dividend pusher obliges the issuing ADI to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term 'cancel distributions/payments' means extinguish these payments. It does not permit features that require the ADI to make distributions/payments in kind.

12. Neither the ADI nor a related party over which the ADI exercises control or significant influence can have purchased the instrument, and the ADI cannot have funded (directly or indirectly) the purchase of the instrument.
13. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a SPV), proceeds must be immediately available without limitation to an operating entity[42] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

42 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Appendix 4 – Criteria for inclusion in Tier 2 capital

1. Issued and paid-in.
2. Subordinated to depositors and general creditors of the ADI.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general ADI creditors.
4. Maturity:
   (a) minimum original maturity of at least five years;
   (b) recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis; and
   (c) there are no step-ups or other incentives to redeem.
5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option an ADI must receive prior supervisory approval;
   (b) an ADI must not do anything that creates an expectation that the call will be exercised;[43] and
   (c) an ADI must not exercise a call unless:
      (i) it replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the ADI;[44] or
      (ii) the ADI demonstrates that its capital position is well above its PCR after the call option is exercised.
6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
7. The instrument cannot have a credit sensitive dividend feature (i.e. a dividend/coupon that is reset periodically based in whole or in part on the ADI's credit standing).
8. Neither the ADI nor a related party over which the ADI exercises control or significant influence can have purchased the instrument, and the ADI cannot have funded (directly or indirectly) the purchase of the instrument
9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a SPV), proceeds must be immediately available without limitation to an operating entity[45] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.

43 An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the ADI does not do anything that creates an expectation that the call will be exercised at this point.

44 Replacement issues can be concurrent with but not after the instrument is called.

45 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Appendix 5 – Minority interest and other capital issued out of consolidated subsidiaries that is held by third parties

Common shares issued by consolidated subsidiaries

In line with the Basel III rules text, APRA proposes to allow recognition in Common Equity Tier 1 of minority interest arising from the issue of common shares by a fully consolidated subsidiary of the ADI only if:

- the instrument giving rise to the minority interest would, if issued by the ADI, meet all of the criteria for classification as common shares for regulatory capital purposes; and
- the subsidiary that issued the instrument is itself an ADI (or overseas equivalent).

The amount of minority interest recognised in consolidated Common Equity Tier 1 will be the total amount of minority interest meeting the two criteria above, less the amount of the surplus Common Equity Tier 1 of the subsidiary attributable to the minority shareholders, where:

- surplus Common Equity Tier 1 of the subsidiary is calculated as the Common Equity Tier 1 of the subsidiary minus the lower of:
  - the minimum Common Equity Tier 1 requirement of the subsidiary plus the capital conservation buffer (e.g. seven per cent of risk-weighted assets); and
  - the portion of the consolidated minimum Common Equity Tier 1 requirement plus the capital conservation buffer (e.g. seven per cent of consolidated risk-weighted assets) that relates to the subsidiary; and
- the amount of the surplus Common Equity Tier 1 that is attributable to the minority shareholders is calculated by multiplying the surplus Common Equity Tier 1 by the percentage of Common Equity Tier 1 that is held by minority shareholders.

Tier 1 qualifying capital issued by consolidated subsidiaries

APRA proposes to allow recognition of Tier 1 capital instruments issued by a fully consolidated subsidiary of the ADI to third-party investors (including amounts of common shares and Additional Tier 1 instruments issued by consolidated subsidiaries) only if the instruments would, if issued by the ADI, meet all of the criteria for classification as Tier 1 capital.

The amount of this capital that will be recognised in Tier 1 will be the total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third-party investors, where:

- surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of:
  - the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (e.g. 8.5 per cent of risk-weighted assets); and
  - the portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (e.g. 8.5 per cent of consolidated risk-weighted assets) that relates to the subsidiary; and
- the amount of the surplus Tier 1 that is attributable to the third-party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third-party investors.

The amount of this Tier 1 capital that will be recognised in Additional Tier 1 will exclude amounts recognised in Common Equity Tier 1 as outlined above.

Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries

Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the ADI to third-party investors (including amounts of common shares and Tier 1 qualifying capital issued by consolidated subsidiaries) may receive recognition in Total Capital only if the instruments would, if issued by the ADI, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

The amount of this capital that will be recognised in consolidated Total Capital will be the total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third-party investors where:

- surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of:
  - the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (e.g. 10.5 per cent of risk-weighted assets);
  - the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (e.g. 10.5 per cent of consolidated risk-weighted assets) that relates to the subsidiary; and
- the amount of the surplus Total Capital that is attributable to the third-party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third-party investors.

The amount of this Total Capital that will be recognised in Tier 2 will exclude amounts recognised in Common Equity Tier 1 under common shares issued by consolidated subsidiaries and amounts recognised in Additional Tier 1 under Tier 1 qualifying capital issued by consolidated subsidiaries.

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