Response to Submissions

Implementing Basel III capital reforms in Australia

30 March 2012

Preamble

In September 2011, the Australian Prudential Regulation Authority (APRA) released a discussion paper, *Implementing Basel III capital reforms in Australia*, outlining its proposals to implement 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'.

Submissions on APRA's Basel III capital proposals were due by 2 December 2011. APRA received 13 submissions, which broadly supported the adoption of the Basel III reforms in Australia, but raised several issues for APRA to consider.

This paper outlines the main issues raised in submissions and APRA's response. Concurrently, APRA is releasing five draft prudential standards for further public consultation:

Prudential Standard APS 001 Definitions (APS 001);

Prudential Standard APS 110 Capital Adequacy (APS 110);

Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111);

Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements (APS 160); and

Prudential Standard APS 222 Associations with Related Entities (APS 222).

APRA intends to release its proposed approaches to the implementation of the Basel III reforms relating to counterparty credit risk and Pillar 3 disclosures once the Basel Committee has finalised these particular reforms.

APRA will also consult later in the year on reporting standards and consequential amendments to other prudential standards required to implement the Basel III capital reforms. Final prudential standards and reporting forms will come into effect on 1 January 2013.

This discussion paper and the draft prudential standards are available on APRA's website at www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx.Written submissions should be forwarded by 31 May 2012 by email to Basel3capital@apra.gov.au and addressed to:

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Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

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AASB 13	*AASB 13 Fair Value Measurement*
AASB 139	*AASB 139 Financial Instruments: Recognition and Measurement*
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 001	*Prudential Standard APS 001 Definitions*
APS 110	*Prudential Standard APS 110 Capital Adequacy*
APS 111	*Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*
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APS 160	*Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements*
APS 222	*Prudential Standard APS 222 Associations with Related Entities*
ASIC	Australian Securities and Investment Commission
ASX	Australian Securities Exchange
Basel Committee	Basel Committee on Banking Supervision
Basel Committee FAQs	*Basel III Definition of Capital – Frequently Asked Questions*, Basel Committee, December 2011
Basel II Framework	*Basel II: International Convergence of Capital Measurement and Capital Standards A Revised Framework,* Basel Committee, June 2006
Basel III	*Basel III: A global regulatory framework for more resilient banks and banking systems,* Basel Committee, December 2010 (revised June 2011)
Corporations Act	*Corporations Act 2001*
ELE	Extended Licensed Entity
ICAAP	Internal Capital Adequacy Assessment Process
Mutual ADI	An ADI operating under a mutual corporate structure in accordance with *Regulatory Guide 147 Mutuality – Financial Institutions,* ASIC, September 2000
NOHC	Non-operating holding company
PCR	Prudential Capital Requirement (previously Prudential Capital Ratio)
SPV	Special purpose vehicle

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). In September 2011, APRA released a discussion paper outlining its proposals to implement these Basel III capital reforms in Australia and invited submissions on those proposals. Thirteen submissions were received.

Minimum capital requirements

APRA proposed to adopt the Basel III definition of regulatory capital, 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. It also proposed to adopt the Basel III adjustments to capital that are specified as minimum requirements, with only minor exceptions. However, it did not propose, for *in-principle* reasons, to adopt a concessional treatment for certain items in calculating regulatory capital, a discretion available under the Basel III reforms.

One theme in submissions was that, by not adopting the concessional treatment, APRA's more conservative approach would lead to published 'headline' capital ratios for authorised deposit-taking institutions (ADIs) that are lower than headline ratios of banks in jurisdictions where the discretions are exercised. In APRA's assessment, however, adoption of the concessional treatment would not be consistent with the principle of raising the quality and quantity of regulatory capital in Australia. APRA also notes that a common disclosure template recently proposed by the Basel Committee would, if implemented, largely address concerns about the international comparability of regulatory capital ratios.

Another theme in submissions was that the Basel III reforms presented particular difficulties for ADIs with a mutual corporate structure, which are unable to issue ordinary shares. APRA acknowledges this concern and will consult separately with mutual ADIs on the issues raised. However, it does not see these issues as a reason for departing from its longstanding policy of applying a common set of prudential requirements across the ADI industry.

In brief, APRA is not intending to change its broad approach to the implementation of the Basel III reforms in Australia.

However, in response to issues raised in submissions, APRA is proposing to provide:

- more flexibility on the mechanisms to ensure greater loss absorbency on Additional Tier 1 and Tier 2 capital instruments;
- a reduced reporting burden for unrealised gains and losses before the adoption of *AASB 9 Financial Instruments*; and
- clarifications on a number of technical elements of its Basel III proposals.

Capital buffers

Basel III introduces two capital buffers. The capital conservation buffer is designed to ensure that ADIs build up capital buffers outside periods of stress that can be drawn down as losses are incurred. The countercyclical buffer is 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. Capital distribution constraints will be imposed on an ADI when its capital levels fall within the buffer range.

APRA proposed to introduce the buffer regime in line with the Basel III reforms. Notwithstanding some concerns raised in submissions, including in relation to mutual ADIs, APRA sees no reason to depart from these reforms. APRA is also confirming that it will retain the 'profits test' (under which APRA's approval is required by an ADI to pay dividends in excess of its after-tax earnings) as an important complement to the capital conservation buffer.

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 proposed to introduce this measure in line with the Basel III reforms. The leverage ratio attracted little comment in submissions.

Disclosure

In December 2011, the Basel Committee released for consultation its proposals to improve consistency and ease in use of disclosures on capital positions and capital composition. These proposals include a common template and disclosure provisions that, if implemented, would facilitate comparison between the capital position of ADIs across jurisdictions. APRA will consult further on the final disclosure requirements when they are released by the Basel Committee.

Transitional arrangements

Basel III provides generous transitional arrangements for the new Basel III capital requirements, in respect of minimum capital ratios, deductions from regulatory capital and capital instruments. In APRA's view, ADIs in Australia are well placed to meet the new requirements and APRA therefore proposed to adopt an accelerated timetable for introduction of the Basel III minimum capital ratios and regulatory adjustments, and the capital conservation buffer. APRA broadly proposed to adopt the Basel III phaseout arrangements for capital instruments that no longer qualify as Additional Tier 1 Capital or Tier 2 Capital.

Some submissions questioned the accelerated timetable but, in APRA's view, this timetable is not a demanding one. ADIs already meet the minimum Common Equity Tier 1 target set for 1 January 2013. In response to submissions, however, APRA is now proposing to adopt the Basel III transitional arrangements for ineligible capital instruments issued by consolidated subsidiaries and held by third parties, rather than require full deduction from 1 January 2013.

Consultation with industry and other interested stakeholders

Concurrently with this response paper, APRA is releasing for consultation five draft prudential standards that give effect to the Basel III capital reforms in Australia. The standards, which will come into effect on 1 January 2013, also include revised and expanded requirements for an ADI's Internal Capital Adequacy Assessment Process (ICAAP). APRA invites written submissions on the response paper and draft standards.

Chapter 1 – Introduction

1.1 Overview

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).[1] On 6 September 2011, the Australian Prudential Regulation Authority (APRA) released its discussion paper, *Implementing Basel III capital reforms in Australia*, commencing formal public consultation on Basel III measures relating to the quality, consistency and transparency of capital, capital buffers and the leverage ratio.[2]

In its discussion paper, APRA proposed that it would incorporate into its prudential standards 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 approach. APRA also indicated that it does not propose to exercise the discretion available to national supervisors to adopt a concessional treatment for certain items in determining regulatory capital.

APRA received 13 submissions on its September 2011 discussion paper. This paper summarises the main issues raised in submissions and provides APRA's response. In a number of areas, submissions sought a relaxation of the proposed capital requirements or requested further clarification on their application.

The Basel III reforms are designed to raise the quality and quantity of regulatory capital, enhance the risk coverage of the capital framework and improve the international consistency of capital definitions. The theme of some submissions was that APRA should give priority to the last of these objectives. These submissions argued that APRA should implement the minimum Basel III requirements for the definition and measurement of capital, which the submissions treat as the Basel Committee's rules text *and* the exercise of national discretions available, on the basis that capital ratios for authorised deposit-taking institutions (ADIs) in Australia could then be readily compared with overseas banks. The claim in these submissions was that professional investors do not have the time or resources to delve behind published 'headline' capital ratios to determine whether more conservative capital requirements have been imposed in different jurisdictions.

APRA does not accept the argument in these submissions that the discretion for concessional treatment of certain items should be treated as part of the minimum Basel III requirements. This is a misreading of the Basel Committee's longstanding approach to national discretions, which allow supervisors scope to take a more conservative approach where appropriate to domestic circumstances.

APRA's proposed implementation of the Basel III reforms give priority, instead, to the first two objectives outlined above – viz., to raise the quality and quantity of regulatory capital. In its view, the adoption of the concessional treatment available for certain items in determining regulatory capital would not, in Australia's case, contribute to these objectives, for the *in-principle* reasons set out in the discussion paper. At this stage, APRA is not alone among supervisory agencies in proposing not to adopt this concessional treatment. APRA has not been persuaded by any arguments to the contrary in submissions.

1 *Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011:* www.bis.org/publ/bcbs189.htm

2 www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-September-2011.aspx The paper did not address the Basel III capital treatment of counterparty credit risk or Pillar 3 disclosures, which will be the subject of separate consultation.

Accordingly, APRA is not intending to change its broad approach to the implementation of the Basel III reforms in Australia.

APRA acknowledges that, by excluding certain items from capital calculations, published headline capital ratios for ADIs in Australia will be lower than headline ratios of banks in jurisdictions where the discretions are exercised. Headline capital ratios for ADIs in Australia are already lower than international peers because of APRA's conservative approach to capital, and consistent global application of the minimum Basel III requirements will narrow this gap. Moreover, APRA has seen no evidence that the current differences in headline capital ratios have created disadvantages for ADIs in Australia in accessing global capital and funding markets. On the contrary, despite lower headline capital ratios:

- the larger Australian banks have had little difficulty in raising equity capital since the global financial crisis began, with some issues heavily oversubscribed;
- the major Australian banks have not faced a higher cost of funds than similarly rated peers; and
- APRA's conservative approach to capital adequacy is readily acknowledged by credit rating agencies and the major Australian banks remain within a small pool of highly rated banks globally.

APRA also notes that the Basel Committee, in December 2011, released for public consultation a proposal for a standardised template for the disclosure of capital positions under Basel III. Such a template, if adopted, would enable investors and analysts to make cross-border comparisons of banking institutions in a straightforward and efficient way.

Some other submissions argued that, since the Basel III reforms are global minimum capital requirements for internationally active banks, the reforms should not be applied to all ADIs in Australia. APRA does not accept this argument. Unlike other jurisdictions, banks, credit unions and building societies in Australia are supervised under the same legislative regime and APRA's longstanding policy is to apply a common set of prudential requirements across the ADI sector. When appropriate, these requirements can take account of an individual ADI's size, complexity and risk profile. In APRA's view, the Basel III reforms will improve the regulatory capital framework for ADIs and, in so doing, strengthen the protection available for depositors and the resilience of the Australian banking system as a whole. There are, nonetheless, certain aspects of the Basel III reforms that are problematic for mutually owned ADIs (mutual ADIs). APRA intends to consult separately with mutual ADIs on these aspects.

In the chapters that follow, APRA has clarified its requirements for the definition and measurement of regulatory capital, and for the application of capital buffers. Where appropriate, it has also modified its proposals on the basis of issues raised or suggestions made in submissions. The particular issues for mutual ADIs are covered separately.

1.2 Draft prudential standards

Concurrently with this response paper, APRA is releasing for consultation five draft prudential standards that give effect to the Basel III capital reforms in Australia. These prudential standards will come into effect from 1 January 2013.

The standards are:

Prudential Standard APS 001 Definitions (APS 001);

Prudential Standard APS 110 Capital Adequacy (APS 110);

Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111);

Prudential Standard APS 160 Capital Adequacy: Basel III Transitional Arrangements (APS 160); and

Prudential Standard APS 222 Associations with Related Entities (APS 222).

APS 001 is a new prudential standard defining terms used across APRA's prudential standards and prudential practice guides for ADIs, comparable in intent to the existing general insurance standard *Prudential Standard GPS 001 Definitions.*

APS 110 and APS 111 incorporate the Basel III capital requirements and reflect the proposals outlined in the September 2011 discussion paper and in this response paper. APRA has removed any reference to capital adequacy requirements at Level 3, pending the implementation of APRA's Level 3 framework through separate prudential standards from April 2013.

APRA has also taken the opportunity to revise and expand its requirements for an ADI's Internal Capital Adequacy Assessment Process (ICAAP), to take account of observed good practice internationally[3] and to align ADI requirements more closely with those APRA intends to implement for the general and life insurance industries.[4] In particular, APRA is proposing that APS 110 introduce requirements for ADIs to:

- ensure the ICAAP includes stress testing and scenario analysis;
- implement appropriate processes for reporting to an ADI's Board of directors on the ICAAP and its outcomes;
- implement policies to address material risks not covered by explicit regulatory capital requirements; and
- prepare an ICAAP summary statement and an ICAAP report to be submitted to APRA annually.

APRA has decided to incorporate its Extended Licensed Entity (ELE) requirements in APS 222, which deals with intra-group matters, instead of in APS 110 where they currently reside. There are no other substantive amendments to APS 222.

1.3 Further consultation

Comments are invited on the revised proposals set out in this response paper and on the draft prudential standards.

Further consultation will be undertaken later this year on reporting standards and consequential amendments to other prudential standards to give effect to the Basel III capital reforms.

3 Including requirements in the Basel Committee's *Enhancements to the Basel II framework*, July 2009, www.bis.org/publ/bcbs157.htm

4 Refer to *Response to Submissions: Review of capital standards for life and general insurers,* December 2011, www.apra.gov.au/GI/PrudentialFramework/Documents/LAGIC_RP_final_290212.pdf

Chapter 2 – Minimum capital requirements

2.1 Definition of capital

In its September 2011 discussion paper, APRA proposed to adopt the Basel III definition of regulatory capital, under which common equity is the predominant form of Tier 1 Capital. In addition, APRA set out its proposals for the adoption of 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.

Submissions were broadly supportive of APRA's proposals in these areas.

Common Equity Tier 1 Capital: deferred fee income

APS 111 currently allows deferred fee income to be included in current year's earnings in Fundamental Tier 1 capital under specified conditions. These conditions include a requirement that payment must have been received and there is no recourse by the customer for a refund. This approach is consistent with APRA's prudential treatment of certain items under the Australian equivalent of International Financial Reporting Standards.

Comments received

Submissions sought clarification as to whether APRA would continue to allow deferred fee income to be included in Common Equity Tier 1 Capital.

APRA's response

The Basel III rules text does not specifically exclude deferred fee income from Common Equity Tier 1 Capital. APRA therefore proposes to include this item in Common Equity Tier 1, subject to the existing conditions.

Common Equity Tier 1 Capital: additional reporting of unrealised gains and losses

Comments received

One submission observed that APRA's proposed additional reporting requirements for unrealised gains and losses before the adoption of *AASB 9 Financial Instruments* (AASB 9)[5] will considerably reduce the timeframe available for implementing these new accounting requirements.

The submission recommended that the additional information be reported to APRA when the AASB 9 financial statements are published and suggested that APRA rely on the transition disclosures in *AASB 7 Financial Instruments: Disclosures* (AASB 7). These transition disclosures reconcile the current accounting requirements in *AASB 139 Financial Instruments: Recognition and Measurement* (AASB 139) with the new accounting requirements in AASB 9. This approach would reduce reporting burdens.

APRA's response

APRA accepts this recommendation and does not intend imposing additional reporting requirements prior to the adoption of AASB 9. APRA will rely on the transition disclosures provided in AASB 7.

Common Equity Tier 1 Capital: fair value practices

Comments received

APRA proposed quarterly reporting of cumulative gross unrealised gains and losses recognised in the Statement of Financial Position (or balance sheet) for fair values that are valued using Level 2 and Level 3 inputs.[6] One submission asserted that this proposal would be unreasonably burdensome for industry as it goes beyond the accounting requirements in *AASB 13 Fair Value Measurement* (AASB 13).

5 *AASB 9 Financial Instruments* as amended in December 2011 applies to annual reporting periods beginning on or after 1 January 2015.

6 The Level 1, 2, and 3 inputs used for measuring fair values are defined in accordance with *AASB 13 Fair Value Measurement*. These requirements apply to annual reporting periods beginning on or after 1 January 2013.

APRA's response

Basel III allows all unrealised gains and losses recognised on the balance sheet to be included in Common Equity Tier 1 Capital. This treatment is based on the presumption that unrealised fair value gains and losses included in capital calculations are reliable.

APRA's view is that Level 2 and Level 3 inputs are not as reliable as Level 1 inputs in providing evidence of fair value.[7] Given that, for some ADIs, instruments fair-valued using Level 2 and Level 3 inputs can represent a material amount of the balance sheet, APRA intends to continue with its proposal and will require quarterly reporting of cumulative gross unrealised gains and losses for fair values that are valued using Level 2 and Level 3 inputs.

Common Equity Tier 1 Capital: application to ADIs with a mutual corporate structure

A key concern of mutual ADIs is their limited ability to raise complying Common Equity Tier 1 Capital, other than through retained earnings, since mutual ADIs are unable to issue ordinary shares. APRA proposed to adopt the Basel III criteria for classification as common shares for regulatory capital purposes. Under the Basel III rules text (page 13), these criteria also apply to non-joint stock companies such as mutuals, 'taking into account their specific constitution and mutual structure'. However, 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 to not possess features which could cause the condition of the [ADI] to be weakened as a going concern in times of stress'.

One criterion for classification as common equity under Basel III is a prohibition against a contractual cap (except to the extent that a banking institution is unable to pay distributions that exceed the level of distributable items).

Comments received

The prohibition on a contractual cap on distributions was considered in some submissions to be an insurmountable impediment to mutual ADIs issuing capital that could be deemed to be ordinary shares because, under a requirement of the Australian Securities and Investment Commission (ASIC), dividends in 'investor shares issued by a mutual entity must be limited by reference to an external benchmark or not more than a fixed percentage of the company's annual profit after tax'.[8]

One submission pointed to the approach taken by the European Commission in its draft *Capital Requirements Regulation* as a means to facilitate the issue of ordinary shares by mutual ADIs. Article 25 of this draft allows mutually-owned banking institutions to include a cap on distributions where this is allowed under the relevant jurisdiction's legislative framework and the instrument does not possess features that could weaken the institution as a going concern during periods of market stress.

7 This is consistent with paragraph 77 of AASB 13 which states: 'A quoted price in an active market provides the most reliable evidence of fair value.'

8 ASIC *Regulatory Guide 147 Mutuality – Financial institutions,* September 2000, paragraph 147.39(c).

APRA's response

APRA notes that the purpose of the Basel III prohibition on a contractual cap on distributions is to ensure that banking institutions have full and unfettered discretion to restrict or cancel dividends where needed to maintain an appropriate level of capital. APRA understands that instruments providing for the payment of dividends by reference to an external benchmark or a fixed proportion of after-tax profits will not be inconsistent with the Basel III prohibition provided that:

- there is no linkage between dividend payments and the price paid at issuance;
- the amount is a maximum amount, does not operate as a *de facto* minimum and the ADI retains full discretion to reduce or waive distributions/payments where necessary; and
- there are no other features that could weaken the ADI as a going concern during periods of market stress.

APRA believes that such an approach could alleviate the primary concern of mutual ADIs about constructing an instrument that may be deemed to be equivalent to ordinary shares under Basel III, and it invites further submissions on this issue.

Additional Tier 1 Capital: dividend stoppers

Comments received

Submissions sought clarification as to whether APRA will allow dividend stopper arrangements under which an ADI is prevented from making a dividend payment on ordinary shares as result of a failure to make dividend/coupon payments on other instruments.

Submissions also queried whether:

- a dividend stopper of six months, being the typical interval for ordinary dividends, would be acceptable;
- payments on instruments should not occur more frequently than half-yearly to avoid disrupting the implied ranking between capital instruments if a dividend stopper were lifted after payment within a shorter accrual period; and
- dividend stoppers should apply to both dividends and distributions on all securities that are *pari passu* or more junior to the hybrid security.

APRA's response

The Basel III criteria for Additional Tier 1 Capital prohibited restrictions on an ADI arising from the cancellation of distributions or payments. This appeared to rule out dividend stoppers. However, the Basel Committee clarified in its *Basel III definition of capital – Frequently asked questions*[9] (Basel Committee FAQs) that dividend stopper arrangements are not prohibited by the Basel III rules text so long as they do not impede an ADI's discretion to cancel distributions or payments on an Additional Tier 1 instrument and do not hinder any recapitalisation efforts. APRA now proposes to allow dividend stoppers in line with the Basel Committee FAQs.

The Basel Committee FAQs also advised that a dividend stopper would not be allowed to prevent distributions to shareholders that extend beyond the point in time that dividends/coupon payments on the Additional Tier 1 instruments are resumed. Draft APS 110 has adopted the Basel III approach and does not specify a time period for dividend stoppers; this will depend on the payment period involved.

APRA does not intend to mandate the frequency of payments on instruments. This is a matter for issuing ADIs.

9 Basel Committee, *Basel III definition of capital – Frequently asked questions,* December 2011: www.bis.org/publ/bcbs211.htm

The Basel Committee specifically allows dividend stoppers for Additional Tier 1 capital instruments. APRA does not see any sound reasons to extend the provision to Tier 2 capital instruments.

Tier 2 Capital: caps and limitations

Comments received

One submission queried whether APRA intended to impose specific caps or limitations on the amount of Tier 2 Capital that may be held, as is the case under current requirements.

APRA's response

APRA confirms that it does not intend to limit the amount of Tier 2 Capital that may be held, provided the ADI meets its prudential capital requirements (PCRs) and buffer requirements with the appropriate category of capital.

Tier 2 Capital: incentives to redeem

Comments received

One submission queried whether the interest rate structure of an instrument with no increase in the margin above the pricing benchmark is an incentive to redeem.

APRA's response

APRA proposes to adopt the position set out in the Basel Committee FAQs under which conversion from a fixed rate to floating rate (or vice versa) in combination with a call option without any increase in credit spread will not by itself be viewed as an incentive to redeem. However, as with any call option, an ADI must not do anything that creates an expectation that a call will be exercised.

Additional Tier 1 and Tier 2 Capital: calls within five years

The criteria for inclusion in Additional Tier 1 and Tier 2 Capital require that capital may be callable at the initiative of the issuer only after a minimum of five years, subject to certain conditions. APRA's *Frequently Asked Questions APS 111 Capital Adequacy: Measurement of Capital*[10] (APRA's FAQs) advised that, pending the finalisation of its capital standards, complying instruments may only contain call options within the first five years where these arise through taxation or regulatory events.

Comments received

One submission queried whether APRA would also allow the event of a takeover to justify calls within the first five years. This submission argued that a takeover, like regulatory events, is outside the issuer's control but can affect the fundamental economics of an instrument. Accordingly, such instruments should be redeemable, subject to appropriate capital substitution. It was also argued that restructuring hybrid instruments is factored into takeover decisions. An ADI would also benefit in that the instrument can be accounted for as a liability, which would allow revaluation for foreign exchange movements; this would encourage the issue of foreign currency-denominated hybrid capital as a diversification of capital sources.

Another submission expressed concern that the Basel Committee's FAQs indicated that ADIs should not expect supervisors to allow a call if the intention is to replace the instrument with one issued at a higher credit spread.

10 *Frequently Asked Questions APS 111 Capital Adequacy: Measurement of Capital*, revised August 2011, www.apra.gov.au/adi/Documents/ADI_FAQ_APS111_082011_v1[1].pdf

APRA's response

APRA's decision to allow an instrument to be called within the first five years for tax and regulatory events is in line with the Basel III requirements outlined in the Basel Committee FAQs. The Basel Committee has confirmed that no other events are intended to be included and APRA agrees with this approach.

APRA agrees with the Basel III position that an ADI calling an instrument and replacing it with a more costly one might create an expectation that the ADI will exercise calls on its other capital instruments. However, APRA will be prepared to consider individual instances where an ADI believes that replacing an instrument with a more costly one is appropriate and does not create an ongoing expectation that other calls will be exercised.

Additional Tier 1 and Tier 2 Capital: substitution of issuer

Comments received

The argument was put that APRA's position on allowing for the substitution of an issuer only where the capital is replaced is inflexible and does not address the situation where an ADI is seeking to implement a non-operating holding company (NOHC) structure.

APRA's response

APRA's position is that no transfer of capital within a group will be permitted if, as a consequence, the ADI will become inadequately capitalised. APRA proposes to retain its general rule that prevents open-ended substitution of issuer clauses and allows substitution of an issuer only where the capital is directly replaced. However, APRA will continue to review restructuring proposals on a case-by-case basis, taking account of the allocation of capital within that structure.

Additional Tier 1 and Tier 2 Capital: resale and sale mechanisms

Comments received

Confirmation was sought that provisions in hybrid instruments offering either a resale facility (whereby the issuer can require that a third party acquire the securities prior to exchange or in lieu of redemption) or a sale facility (whereby the issuer facilitates the easy sale of shares received due to an exchange) do not breach APRA's proposed requirements. Such facilities, it was claimed, have been included in capital instruments issued by other Australian corporate institutions. The argument put to APRA was that a resale facility allows the issuer to manage conversion/exchange of shares without flooding the market and that a sale facility provides an easy mechanism for overseas holders to dispose of shares.

APRA's response

APRA does not intend to prohibit resale and sale mechanisms provided that these do not impede immediate conversion where this is required to meet loss absorption or non-viability requirements.

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

Comments received

Under Basel III, minority interest arising from the issue of capital by a consolidated subsidiary that is held by third parties may be included in the regulatory capital of the consolidated banking group if the capital instrument meets certain conditions. The amount that may be included is calculated by reference to the capital position of the subsidiary relative to its regulatory capital requirement and to the amount of surplus capital attributable to the third-party investors. Clarification was sought as to whether an ADI should calculate the capital position of an overseas subsidiary according to the regulatory requirements of the host regulator or under APRA's prudential requirements.

APRA's response

ADIs should calculate the capital position of overseas subsidiaries according to APRA's Level 2 regulatory capital requirements.

Dividend reinvestment plans

Comments received

One submission noted that the criteria for Common Equity Tier 1, Additional Tier 1 and Tier 2 Capital included the requirement that 'the ADI cannot directly or indirectly have funded the purchase of the instrument'. Clarification was sought that this is not intended to preclude securities issued through dividend reinvestment plans operated by an ADI.

Another issue raised was whether an ADI would need to deduct from regulatory capital any shares in the ADI that it had funded by a loan to a retail margin loan borrower or any other borrower involved in share market investing activities. It was noted that the *Corporations Act 2001* (Corporations Act) allows an ADI to finance its own shares through a margin loan arrangement where this is undertaken in the ordinary course of providing finance and is provided on ordinary commercial terms.

APRA's response

Under APRA's Basel III proposals, dividends are to be deducted when declared. No allowance is necessary for dividend reinvestment plans, which are no longer relevant for determining Common Equity Tier 1 Capital.

The Basel III criteria for Common Equity Tier 1 Capital exclude shares that have been directly or indirectly funded by the ADI. This includes holdings of the ADI's shares by retail margin loan customers and other borrowers from the ADI involved in share market investing. APRA is adopting this exclusion.

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

The Basel III reforms require that all regulatory capital instruments must be capable of bearing loss. To achieve this objective, the terms and conditions of all Additional Tier 1 and Tier 2 instruments issued by ADIs must provide for such instruments to be either converted into common equity or written off upon the occurrence of a trigger event. The Basel III definition of the trigger event is where APRA determines that, without conversion or write-off, or a public sector injection of funds, an ADI would become non-viable (the non-viability requirements). Specifically, APRA proposed that the non-viability requirements must be incorporated in the contractual terms and conditions of each Additional Tier 1 and Tier 2 instrument issued from 1 January 2013.

APRA further proposed that full write-off would be the default provision unless APRA otherwise approved a conversion mechanism. If approved, the non-viability requirements needed to provide for conversion of Additional Tier 1 and Tier 2 instruments to listed equity only.

Conversion or write-off

Comments received

Some submissions indicated a preference for conversion over write-off as the primary mechanism to meet the non-viability requirements. Another requested that APRA draft its prudential standard broadly, to allow ADIs to determine the conversion mechanism (which would be subject to APRA's approval before issue).

APRA's response

APRA acknowledges the arguments in favour of conversion over write-off, and draft APS 111 provides that ADIs can elect to convert instruments into common equity upon the occurrence of the non-viability trigger. However, all Additional Tier 1 and Tier 2 instruments must also provide for write-off in the event that conversion is unable to be effected immediately or does not result in an unequivocal increase in Common Equity Tier 1 Capital.

Conversion to unlisted equity

Comments received

Submissions queried APRA's proposal to require conversion of regulatory capital instruments at the point of non-viability into listed equity only. Some submissions sought clarification about how conversion to listed equity would work in practice where an instrument is issued by an unlisted subsidiary. Submissions suggested a number of alternatives, including temporary write-off or conversion.

APRA's response

APRA intends to retain its proposed requirement that conversion of a regulatory capital instrument must be into the listed shares of the ADI or an upstream company, where the ADI or upstream company is listed on a recognised stock exchange at the instrument's issue date. Subsequent delisting of the ADI or upstream company will not make the instrument ineligible for inclusion in regulatory capital. Where conversion (into listed or unlisted shares) is not able to occur, the instrument must default to write-off. APRA's concern is to ensure that, in the event that an ADI becomes non-viable, the instrument converts into an existing type of share and does not create a new class of shareholder.

APRA does not support the alternatives suggested in submissions. The Basel III requirement is for permanent write-off or conversion, and APRA agrees with this position.

Hierarchy of loss

Comments received

Several submissions were concerned to preserve the hierarchy between Additional Tier 1 and Tier 2 instruments and between these instruments and Common Equity Tier 1. One submission recommended that each class of instrument be treated equally – i.e. Additional Tier 1 instruments should all be converted or written-off equally and separately, and similarly with Tier 2 instruments.

APRA's response

APRA does not intend to mandate the order of conversion or write-off within the different categories of capital. APRA's concern, rather, is with the restoration of capital should a trigger event occur. APRA will not object to issue documentation providing for a hierarchy of conversion or write-off, provided it is clear that conversion or write-off will occur where necessary.

Partial or full conversion or write-off

Comments received

Clarification was also sought as to whether conversion/write-off should be partial or full.

APRA's response

The Basel Committee FAQs confirm that, in the case of Additional Tier 1 instruments accounted for as liabilities, the aggregate amount to be converted/written off on breaching the loss-absorbency trigger level (defined by APRA as a Common Equity Tier 1 ratio of 5.125 per cent) must be at least the amount needed to immediately return the institution's Common Equity Tier 1 ratio to the trigger level. If this is not possible, the amount to be converted or written off must be the full principal value of the instruments. Consistent with this approach, conversion/write-off of Additional Tier 1 and Tier 2 capital instruments at the point of non-viability may be partial or full provided the ADI restores its capital position to APRA's satisfaction. However, APRA will not approve partial conversion or write-off in those exceptional circumstances where a public sector injection of funds is deemed necessary.

Tax effects

Comments received

A query was raised as to what value, for regulatory capital purposes, an Additional Tier 1 or Tier 2 instrument should receive, having regard to any potential tax liabilities that might be generated as a result of write-off or conversion.

APRA's response

The Basel Committee FAQs state that an instrument may receive recognition in Additional Tier 1 Capital only up to the minimum level of Common Equity Tier 1 Capital that would be generated through full write-off or conversion. Accordingly, the amount of the instrument recognised in Additional Tier 1 Capital must be net of any potential tax liability that may be generated through write-off or conversion. This principle also applies to Tier 2 instruments.

Conversion ratio

In the September 2011 discussion paper, APRA proposed a change in the current maximum conversion ratio, from being based on 50 per cent of the ordinary share price at the time of issue to 20 per cent.

Comments received

APRA received a number of suggestions about the most appropriate method for calculating the number of shares into which regulatory capital instruments would convert. These included:

- allowing the share price on which conversion is based to be reset periodically to account for major capital raisings;
- providing for different conversion ratios to preserve the hierarchy between Additional Tier 1 and Tier 2 instrument holders, such as requiring a maximum of 20 per cent of the share price at issue date for the former and 10 per cent for the latter; and
- adopting other benchmarks, such as net tangible assets per share or the book value per share from the most recent published financial results.

Another submission sought clarification as to whether conversion could occur at face value and whether write-off would be required before conversion. The submission requested confirmation that the same floor would apply to provisions for loss absorption for Additional Tier 1 instruments classified as liabilities for accounting purposes, and to meet non-viability requirements.

APRA's response

Although the Basel III rules text does not provide for an explicit conversion limit, APRA believes that a limit is necessary to enable an ADI to readily quantify the maximum dilution effect upfront and to ensure it has prior shareholder approval for any future issue of the required number of shares, in accordance with relevant Australian Securities Exchange (ASX) Listing Rules. However, during the global financial crisis, APRA observed that the maximum conversion ratio was potentially onerous and therefore it proposed the lower limit. APRA believes that this approach has the benefit of certainty and simplicity and it is not persuaded to adopt any of the alternative suggestions offered.

APRA does not oppose ADIs applying different conversion ratios to different classes of instruments as long as the 20 per cent conversion floor is retained. That is, an ADI could provide that the conversion ratio for Additional Tier 1 instruments is based on 30 per cent of the share price at the issue date of the instrument, and 20 per cent for Tier 2 instruments.

The same conversion limit would apply to conversion that occurs because of the loss absorption requirements applying to Additional Tier 1 instruments classified as liabilities for accounting purposes, and to the non-viability requirements applying to Additional Tier 1 and Tier 2 instruments.

Potential impediments to conversion/write-off

Comments received

A concern was raised about potential constraints on timely and effective conversion/write-off arising from the application of other legislation, such as the takeover provisions of the Corporations Act, the *Foreign Acquisitions and Takeovers Act 1975* and the *Financial Sector (Shareholdings) Act 1998*.

APRA's response

Under the Basel III reforms, conversion or write-off of capital instruments at the point of non-viability needs to be effected in a timely manner. In APRA's view, it is the responsibility of investors to satisfy themselves as to whether investment in regulatory capital instruments would breach any legislative requirements should conversion or write-off be triggered. That said, APRA will continue to explore whether there are any legislative impediments to timely conversion/write-off and will, if necessary, take the issue up with government.

Application to mutual ADIs

Comments received

A number of submissions argued that the non-viability requirements were unworkable for mutual ADIs, given their ownership structure and the fact that they do not issue ordinary shares. Submissions claimed that the resource burden of this requirement on mutual ADIs outweighed any regulatory benefit.

APRA's response

As noted in Chapter 1, APRA's longstanding policy is to apply a common set of prudential standards across the ADI industry that can, where appropriate, take account of an individual ADI's size, complexity and risk profile. APRA does not see a case to develop a two-tiered system for capital standards. That said, APRA will continue to engage with mutual ADIs on the practical application of the non-viability principle. In particular, it is willing to consider proposals for capital instruments issued by mutual ADIs that would meet the Basel Committee's goals of improving the quality and loss absorbency of regulatory capital.

Chapter 3 – Regulatory adjustments to capital

Under Basel III, a number of adjustments are applied to regulatory capital – in most cases, to Common Equity Tier 1. Basel III also provides discretion for national supervisors to apply a 'threshold treatment' to give limited recognition to certain items in calculating Common Equity Tier 1. In addition, Basel III applies a risk-weight of 1250 per cent to certain exposures that were previously 50:50 deductions from Tier 1 and Tier 2 under the Basel II Framework.[11]

In its September 2011 discussion paper, APRA proposed to adopt the Basel III regulatory adjustments to capital that are specified as minimum requirements, with only minor exceptions. APRA did not propose to exercise its discretion to apply the threshold treatment.

3.1 Adjustments to Common Equity Tier 1

Treatment of intangibles

Comments received

One submission proposed that APRA discontinue its current linkage of the definition of intangible assets to Australian Accounting Standards. The concern expressed was that some assets held to be intangible under other standards (such as 'right of use' assets) may not be held to be intangible under *AASB 138 Intangible Assets*, while other assets (such as water rights) are intangible for Australian accounting purposes but not in other jurisdictions.

APRA's response

APRA believes it is appropriate that Australian Accounting Standards provide the basis for determining the prudential treatment of intangible assets, although these standards may not provide the full list of items that are inappropriate for inclusion in capital calculations. Draft APS 111 confirms that intangible assets are as defined in Australian Accounting Standards plus any other assets designated in APS 111 to be intangibles.

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

Comments received

APRA received a number of submissions about its proposal to require full deduction of investments in non-consolidated financial institutions and to replace the current 50:50 deduction from Tier 1 and Tier 2 with the Basel III 'corresponding deduction approach'. These submissions proposed that APRA:

- exercise its discretion to apply the Basel III threshold treatment for significant investments in the common shares of non-consolidated financial institutions that in aggregate are less than 10 per cent of an ADI's common equity;
- address its concerns about the double-counting of capital through higher individual PCRs or the forthcoming Level 3 reforms as alternatives to requiring full deduction of such investments; and
- adopt the threshold treatment for non-consolidated financial institution investments held in the trading book.

Submissions variously argued that APRA's position, which would produce lower headline capital ratios for Australian ADIs, would adversely affect the international competitiveness of ADIs and would potentially be harmful to legitimate trading activities, affecting market liquidity and efficiency. One submission argued that APRA's proposal might inhibit ADI investments in wealth management by placing an unreasonable capital imposition on ADIs in comparison with non-regulated entities operating in that industry.

11 *Basel Committee, International Convergence of Capital Measurement and Capital Standards: A Review of Framework,* June 2006

Clarification was sought for:

- the definition of 'financial institutions', such as whether fund managers and their special purpose vehicles (SPVs) would be included. It was suggested that only ADIs and insurers be included;
- the definition of 'net long position', specifically whether positions able to be netted include physical securities and derivatives over the same underlying exposure, including those associated with looking through holdings of index securities and using delta-equivalent amounts as appropriate;
- when the five-day exemption period for underwriting positions begins; and
- APRA's intended application of the 'corresponding deduction approach' under which the deduction is applied to the same tier of capital for which the capital would qualify if it were issued by the ADI itself.

APRA's response

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. APRA's rationale accords with the position originally adopted by the Basel Committee in its 2009 consultation document on Basel III.[12]

Submissions broadly acknowledged the principle that double-counting of capital should be avoided. APRA remains of the view that applying the Basel III threshold treatment is at odds with this principle.

APRA notes that its Level 3 proposals have yet to be finalised and implemented; moreover, the proposals will not apply to all ADIs. The Level 3 regime is not intended, in any event, to weaken the Level 2 regime. APRA also does not consider it appropriate to address the capital treatment of investments in non-consolidated financial institutions by way of Pillar 2 adjustments to PCRs.

APRA, therefore, sees no convincing reason to depart from the approach outlined in the September 2011 discussion paper. It also sees no reason to distinguish between investments held in an ADI's banking or trading book.

On points of clarification:

- APRA has proposed in draft APS 001 that a 'financial institution' is:

  'any institution engaged substantially in one or more of the following activities – banking; leasing; issuing credit cards; portfolio management (including asset management and funds management); management of securitisation schemes; equity, debt securities, currency, futures and commodity trading and broking; custodial and safekeeping services; insurance (both general and life insurance); and similar activities that are ancillary to the conduct of these activities. A financial institution includes an authorised NOHC or overseas equivalent';
- APRA has adopted the Basel III position on 'net long positions' in draft APS 111;
- the five-day exemption period for underwriting positions begins on the day that payment is made to the ADI; and
- APRA will assess the treatment of individual instruments where an ADI is unsure of the relevant tier of capital. APRA is currently harmonising the capital requirements applying to ADIs and to insurers, based on the Basel III requirements.

12 Basel Committee, *Strengthening the resilience of the banking sector,* December 2009; www.bis.org/publ/bcbs164.pdf

Investments in commercial institutions

Comments received

APRA's longstanding position is that ownership of equity or the holding of other investments in commercial institutions is not a normal part of banking business and that such activity, where it is undertaken, should be funded by shareholders, not depositors or other creditors. APRA therefore proposed to require ADIs to deduct relevant investments from Common Equity Tier 1. Submissions acknowledged APRA's position but requested that APRA:

- consider the nature of the underlying investment and allow investments in service-oriented enterprises, where there is a clear relationship to enhancing the efficient delivery of the Australian financial system (such as payments processing centres), to be risk-weighted rather than deducted from Common Equity Tier 1; or
- retain a minimum threshold. Currently, APRA allows a threshold for investments in commercial institutions of up to 0.15 per cent of an ADI's Level 2 capital base for individual investments, and five per cent (at both Level 1 and Level 2) in aggregate, before deduction is required. Individual investments below these thresholds are risk-weighted. One submission argued for an increase of these thresholds, on the basis that such investments provide an appropriately diversified equity portfolio and thereby decrease an ADI's equity risk.

APRA's response

APRA does not see any convincing reason to depart from its *in-principle* position on ADIs holding equity investments in commercial institutions. This position rules out any consideration of the nature of the investments. Accordingly, draft APS 111 requires ADIs to deduct from Common Equity Tier 1:

- all investments in commercial enterprises held in the banking book; and
- underwriting positions in commercial institutions held for more than five working days.

APRA is not proposing a materiality test for the significance of investments in commercial institutions. Under the Basel II Framework, materiality was left to the discretion of national supervisors and that approach is unchanged under Basel III. The current allowance of very small thresholds adds a level of complexity that, in APRA's view, is unwarranted under its approach to Basel III.

Investments in commercial institutions held in the trading book will continue to be treated in accordance with the relevant market risk prudential requirements of *Prudential Standard APS 116 Capital Adequacy: Market Risk*.

Deferred tax assets

Comments received

APRA received two submissions on its proposal to deduct deferred tax assets (net of deferred tax liabilities) in full from Common Equity Tier 1, rather than exercise its discretion to apply the threshold treatment. One submission accepted the merits of APRA's position but urged it to convince its international peers to adopt the same approach on competitiveness grounds. The other submission sought clarification that the amount of deferred tax assets to be deducted would be net of any associated deferred tax liability that would be extinguished if the intangible assets became impaired or derecognised under the relevant accounting standards.

APRA's response

As outlined in the September 2011 discussion paper, deferred tax assets in Australia rely on the future profitability of the ADI to be realised and, as such, are not available to absorb losses on a gone-concern basis. APRA therefore does not propose to allow such assets, whatever their origin, to be included in the calculation of regulatory capital. APRA confirms that the amount of deferred tax assets to be deducted from Common Equity Tier 1 Capital is to be net of any associated deferred tax liability that would be extinguished if the intangible assets become impaired or derecognised under the relevant accounting standards.

Eligible loss versus eligible provision deduction

Comments received

Clarification was sought as to whether APRA will align its position on this deduction with Basel III, under which the eligible provision is calculated before tax and any associated deferred tax asset is deducted.

APRA's response

APRA will be adopting the Basel III position.

3.2 Other capital adjustments

Risk-weighting certain securitisation exposures

Under Basel III, certain securitisation exposures that are currently deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 Capital (refer to *Prudential Standard APS 120 Securitisation* (APS 120)) are to be risk-weighted at 1250 per cent.

Comments received

One submission argued that the Basel III requirement results in an unreasonably onerous capital requirement for these exposures. This submission suggested two alternative approaches.

APRA's response

APRA does not propose to depart from the Basel III requirements. Revised requirements for risk-weighting assets and for securitisations to implement the Basel III capital reforms will be incorporated into *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and APS 120.

Chapter 4 – Capital buffers

The Basel III framework introduces two capital buffers – a capital conservation buffer and a countercyclical buffer – aimed at raising the resilience of the banking system and addressing procyclicality. 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 macro-prudential goal of protecting the banking system from periods of excess credit growth.

In its September 2011 discussion paper, APRA proposed to introduce a capital conservation buffer, comprised of Common Equity Tier 1, of up to 2.5 per cent. The buffer would apply above the PCR for Common Equity Tier 1 determined for each ADI, which may be at or above the Basel III minimum. However, APRA indicated that it will have regard to the cumulative impact of the PCR and the capital conservation buffer, and may choose to set the capital conservation buffer for an ADI at a level below 2.5 per cent. APRA also proposed to introduce the countercyclical buffer regime in line with the Basel III reforms.

4.1 Capital conservation buffer

The profits test and the capital conservation buffer

Comments received

One submission queried APRA's proposal to retain its 'profits test' – under which APRA's approval is required for dividend payments on ordinary shares in excess of an ADI's after-tax earnings – in light of the constraints on distributions when an ADI's Common Equity Tier 1 level falls within the capital conservation buffer range.

APRA's response

APRA sees the profits test as an important complement to the capital conservation buffer regime. The profits test is a longstanding provision that gives APRA discretion to disallow dividends where there are prudential grounds for doing so, even if the ADI is holding Common Equity Tier 1 above the capital conservation buffer range. APRA is not persuaded to remove the test and has consolidated this requirement with other provisions applying to capital reductions in draft APS 110.

Application to mutual ADIs

Comments received

Submissions raised the concern that mutual ADIs are less able than listed ADIs to raise additional Common Equity Tier 1 Capital, other than through retained earnings. It was claimed, for example, that listed ADIs could restrict dividend payments until the capital conservation buffer commences in 2016 and so raise the required 2.5 per cent in Common Equity Tier 1 Capital. It was also claimed that the restrictions on payments of dividends, bonuses and other distributions as a consequence of breaching the capital conservation buffer had little applicability to mutual ADIs.

Some submissions suggested that the capital conservation buffer (and the countercyclical buffer) for mutual ADIs might be met by Additional Tier 1 rather than by Common Equity Tier 1 Capital. It was believed that such an approach would be adopted for mutual institutions in Canada.

Other submissions proposed that mutual ADIs be excluded from application of the buffer or, alternatively, that the buffer be lowered to less than 2.5 per cent of risk-weighted assets.

APRA's response

APRA recognises that mutual ADIs have less flexibility in capital management than listed ADIs, and it will continue to work with mutual ADIs to address this issue. However, as noted above, APRA is not persuaded of the merits of a two-tiered capital regime where, for example, mutual ADIs are simply exempted from the buffer requirements.

Prudential Capital Requirements and the Basel III buffers

Comments received

Some submissions queried APRA's proposal to set PCRs for Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital for individual ADIs. A key concern was that an ADI that has been through the process of converting non-common equity capital to ordinary shares after a trigger event ought to have some latitude to rebuild additional regulatory capital especially since it may take some time for investors to regain confidence in the institution. Another argument was that any Pillar 2 add-ons to Common Equity Tier 1 Capital should not automatically be applied *pari passu* to the PCRs determined for Tier 1 and Total Capital.

One submission noted APRA's intention of re-setting ADIs' PCRs before the Basel III reforms commence in 2013 and recommended that this process be revisited before the introduction of the capital conservation buffer in 2016. It was also submitted that, to remove uncertainty, APRA should advise ADIs of their revised PCRs before the prudential standards are finalised.

Clarification was also sought as to whether APRA will continue to set individual PCRs at both Levels 1 and 2, based on an interpretation of the September 2011 discussion paper that the capital conservation buffer is to apply at Level 2 only.

APRA's response

APRA's PCR framework is, by design, a flexible tool to ensure ADIs have adequate capital to support all the risks in their business and to encourage ADIs to develop and use better risk management techniques. This flexibility also allows APRA to have regard to changes in the risk profile of an ADI and its external environment. The Basel III reforms do not require any substantive changes in the application of this framework. APRA also confirms that the buffer will apply at both Level 1 and Level 2 and APRA will retain the flexibility to set PCRs at both Level 1 and Level 2.

4.2 Countercyclical buffer

Category of capital

Comments received

Some submissions requested that capital other than common equity might be held against the countercyclical buffer, which was not designed to address an individual ADI's risk profile, but broader macroeconomic considerations. In this regard, it was noted that the Basel III rules text indicates that this option is still under consideration by the Basel Committee.[13]

APRA's response

APRA acknowledges that the Basel Committee is continuing to review this issue and, as a member of the Committee, APRA will be participating in this review. Once the review is finalised, APRA will consider whether further changes to its Basel III proposals are required.

13 Footnote 51 of the Basel III text states: 'The Committee is still reviewing the question of permitting other fully loss absorbing capital beyond Common Equity Tier 1 and what form it would take. Until the Committee has issued further guidance, the countercyclical buffer is to be met with Common Equity Tier 1 only.'

Application to mutual ADIs and to ADIs that do not provide credit

Comments received

Concerns were raised about the difficulties of mutual ADIs in building Common Equity Tier 1 to meet any countercyclical buffer, particularly if required to do so within the 12-month notice period envisaged in the Basel III reforms. Submissions noted that mutual ADIs would need to generate an immediate increase in profit equal to 2.5 per cent of total risk-weighted assets to meet the requirement. Some submissions queried whether the countercyclical buffer was appropriate for mutual ADIs. They claimed that mutual ADIs were traditionally conservative in their business models and did not, for instance, write low-doc or no-doc loans.

One submission noted that the countercyclical buffer was driven by excessive credit growth and that it was unfair to apply it to ADIs unlikely to suffer future losses arising from the provision of credit. In other words, ADIs that did not provide credit as part of their business model should not be subject to this buffer. This submission was of the view that the buffer should be addressed by targeting credit risk through increased risk-weights on credit exposures instead of a blanket capital charge.

As with the capital conservation buffer, submissions argued for a selective application of the countercyclical buffer or, alternatively, an extension in the lead time in which to build Common Equity Tier 1 levels.

APRA's response

The countercyclical buffer is a key element of the Basel III reforms. It is intended to ensure that the banking system as a whole has a buffer of capital to protect it against future potential losses associated with excess aggregate credit growth. The buffer is intentionally system-wide and, when deployed in any jurisdiction, will apply to all banking institutions at a uniform rate. APRA's proposals on the countercyclical capital buffer are fully consistent with the Basel III reforms and it sees no reason to depart from them.

The method for calculating the actual buffer applying to a particular ADI will depend on whether the ADI is internationally active or lends only within Australia. An internationally active ADI must calculate the countercyclical buffer by reference to the weighted average of the buffers that are applied by the regulatory authorities in jurisdictions in which the ADI has exposures. This requirement applies irrespective of the corporate structure of the ADI.

APRA acknowledges that some specialised ADIs, notably providers of purchased payment facilities, are not involved in credit intermediation. These ADIs are subject to separate capital standards and will not be subject to the countercyclical capital buffer.

Chapter 5 – Leverage ratio

Basel III introduces a simple, transparent non-risk based leverage ratio that is intended to help contain the build-up of leverage in the banking system and to provide additional safeguards against model risk and measurement error. In the September 2011 discussion paper, APRA proposed to introduce this measure in its prudential capital regime in line with the Basel III reforms.

The leverage ratio received little attention in submissions.

Under Basel III, the leverage ratio is scheduled to migrate to a Pillar 1 requirement on 1 January 2018, with disclosure requirements coming into effect from 1 January 2015. A parallel run period will operate from 1 January 2013 until 1 January 2017, during which period the key obligation on ADIs will be reporting rather than compliance. In the coming months, APRA will be consulting with the industry on the details of reporting, including its form and frequency. APRA does not intend to incorporate the leverage ratio into its prudential standards at this time.

Chapter 6 – Prudential disclosure

In December 2011, the Basel Committee released a consultative document, *Definition of capital disclosure requirements*,[14] outlining its proposals to improve consistency and ease in use of disclosures on capital positions and capital composition. A key objective of these proposals is to enable market participants to compare the capital adequacy of banking institutions across jurisdictions. To this end, the Committee has been seeking feedback on common templates and disclosure provisions covering a banking institution's capital ratios, regulatory adjustments, balance sheet reconciliation and the main features of capital instruments.

Harmonisation

Comments received

As discussed in Chapter 1, some submissions advocated harmonising APRA's capital requirements fully with Basel III to facilitate comparisons between ADIs and their international counterparts. One recommendation was that APRA work with the Basel Committee to expand the Pillar 3 disclosures and, in effect, mandate a reporting regime in accordance with the Basel III reforms. The rationale for a mandated regime was that regulatory imprimatur was needed to emphasise to investors the strength of the Australian regulatory environment, allow ready comparison with peers and assist ADIs in competing in international capital markets.

APRA's response

The Basel Committee's proposals include a common template that would capture details of how individual jurisdictions have applied the Basel III reforms. These details would include amounts involved in any concessional treatment, whether or not supervisory agencies exercised their discretion to apply such a treatment. Use of such a template would make comparisons of capital positions across jurisdictions much more straightforward. APRA notes that industry in Australia has advised the Basel Committee of its broad support for this approach, subject to review of the degree of proposed disclosure. APRA supports the reporting and disclosure framework outlined by the Basel Committee and believes that, if implemented, the framework would go a considerable way to alleviating industry concerns about the international comparability of capital positions. APRA will consult on its proposed implementation of such a framework once the Basel Committee has finalised its position.

14 www.bis.org/publ/bcbs212.htm

Chapter 7 – Transitional arrangements

The Basel Committee set out detailed transitional arrangements for implementing the Basel III reforms, so 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. APRA noted in its September 2011 discussion paper that ADIs in Australia are well placed to meet the new requirements and it therefore proposed to accelerate the transition timetable in some areas.

APRA has separately advised industry of transitional arrangements for capital instruments issued after the release of the Basel III reforms in December 2009.[15] Those transitional arrangements remain in effect until 31 December 2012.

Common Equity Tier 1 Capital

Comments received

One submission proposed that the increased minimum requirement for Common Equity Tier 1 (i.e. 4.5 per cent of total risk-weighted assets) should be phased-in from 2013 until 1 January 2015 in accordance with the Basel III timetable. The argument was that this would place Australian ADIs in the same position as their overseas counterparts.

APRA's response

APRA's proposed timetable is fully consistent with the Basel Committee's stated view that, where they can, banking institutions should comply with the Basel III reforms as soon as possible. Since ADIs in Australia already meet the minimum requirement of a 4.5 per cent Common Equity Tier 1 Capital ratio, no phase-in arrangements for that requirement from 1 January 2013 are necessary – a strong demonstration of the capital strength and resilience of the Australian banking system. APRA also notes other jurisdictions are adopting accelerated implementation timetables.

15 Refer to APRA's letters of 18 December 2009, 17 September 2010, 27 May 2011 and 30 March 2012: www.apra.gov.au/adi/Publications/pages/other-information-for-adis.aspx

Capital issued by consolidated subsidiaries

Comments received

Some submissions queried APRA's proposal to de-recognise from 1 January 2013 all capital instruments issued by consolidated subsidiaries and held by third parties (including minority interests) that are not fully compliant with the Basel III criteria for regulatory capital, rather than adopt the relevant Basel III transitional provisions for minority interests.

APRA's response

APRA's proposal was intended to simplify the transitional arrangements and presumed that, for most ADIs, the amounts involved would be immaterial. Submissions showed, however, that for a small number of ADIs the amounts are not immaterial. Consistent with its willingness to allow transitional arrangements for other noncomplying capital instruments, APRA is prepared to adopt the transitional arrangements for non-complying and other capital instruments held by third parties, as set out in paragraph 94(e) of the Basel III rules text.

Capital conservation buffer

Comments received

Submissions also argued that, to align with the Basel III timetable, the capital conservation buffer should be phased-in from 1 January 2016 instead of being introduced in full from that date, as APRA proposed. This would ensure that Australian ADIs would be operating under similar requirements to their overseas counterparts and would allow ADIs with overseas operations time to respond to any significant divergences with other jurisdictions.

APRA's response

APRA is of the view that ADIs in Australia are already well-placed to meet the capital conservation buffer requirements in full from 1 January 2016 and it sees no reason to delay implementation.

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.

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