



# DISCUSSION PAPER

## Improving the transparency, comparability and flexibility of the ADI capital framework

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# Executive Summary

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Capital is the cornerstone of a bank's financial strength. It affords the capacity for banks to take risks, by providing a source of funding to absorb losses when they arise, without jeopardising the ability of the bank to pay its claims to depositors and other creditors as and when they fall due. Ensuring banks have adequate capital is a core task of prudential regulators.

Since the business of banking is built on trust and confidence, it is essential that banks not only have adequate capital, but also that depositors and other investors are confident that that is the case. In this regard, disclosure has an important role to play as well, allowing stakeholders to understand and assess a bank's capital adequacy, both over time and relative to peers.

In implementing the Basel Committee on Banking Supervision's capital framework, the Australian Prudential Regulation Authority (APRA) has adopted a more conservative approach than the internationally agreed minimum requirements in a number of areas. As a result, the reported capital ratios of Australian authorised deposit-taking institutions (ADIs) will generally be lower than banks of comparable capital strength in other jurisdictions. Concern has been expressed that, if these Australian differences are not well understood, the capital strength of Australian ADIs may be underestimated, which could in turn make it more difficult or costly for ADIs to raise funds and access international capital markets (particularly in times of market disruption or other financial stress).

In its current program of reform of the ADI capital framework, APRA is pursuing three principal objectives:

- **the quantum of capital** - to achieve an overall level of capital that meets the 'unquestionably strong' aspiration set by the Financial System Inquiry (as set out in APRA's July 2017 Information Paper);<sup>1, 2</sup>
- **the allocation of capital** - to improve the risk sensitivity of current capital requirements, where possible, by more appropriately aligning capital requirements to underlying risks (as set out in APRA's February 2018 Discussion Paper);<sup>3</sup> and
- **the comparability of capital** - to improve the transparency, comparability and flexibility of the capital framework where possible, without materially jeopardising either of the other two objectives.

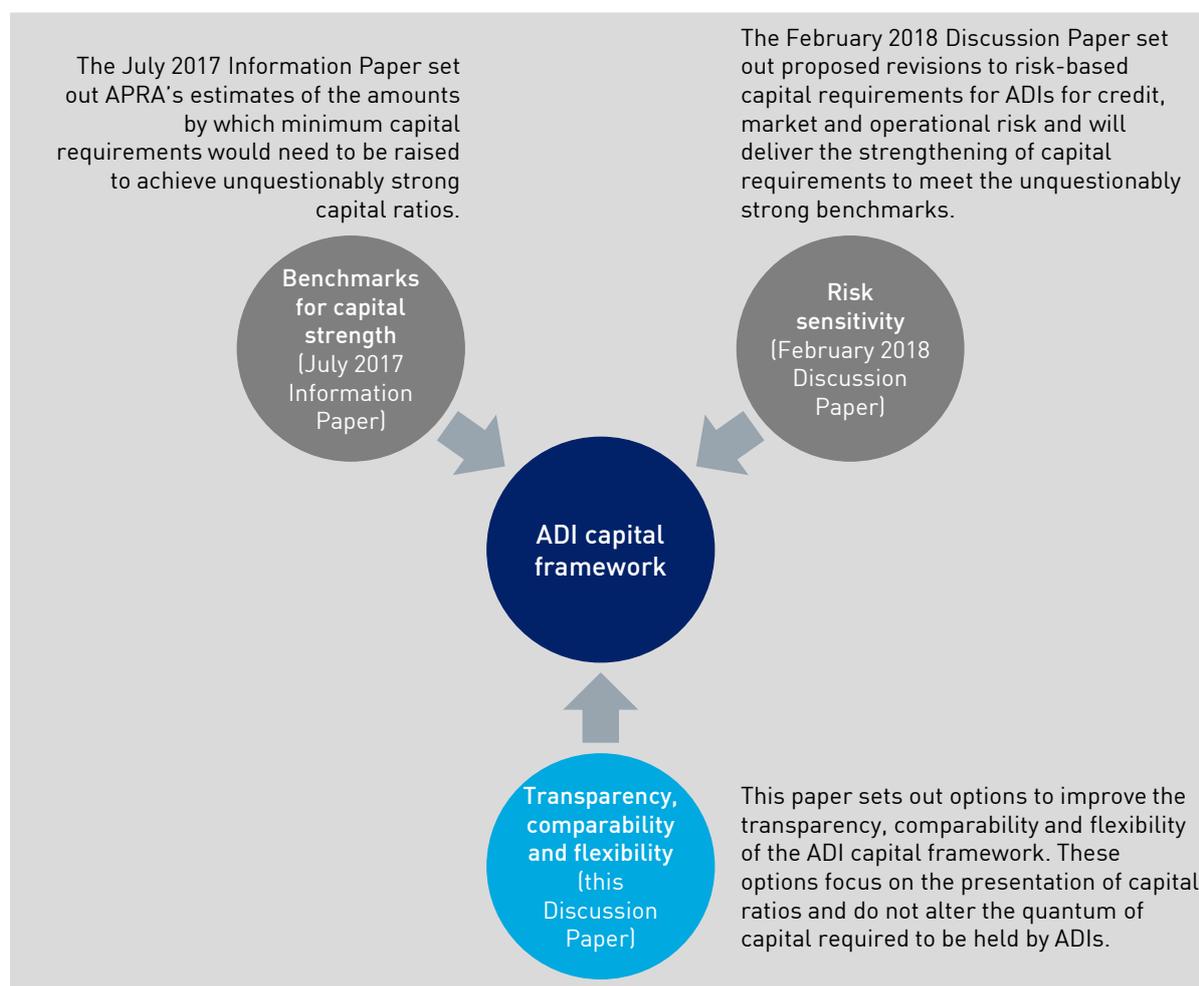
<sup>1</sup> Financial System Inquiry, *Final Report* (November 2014).

<sup>2</sup> APRA, *Strengthening banking sector resilience: establishing unquestionably strong capital ratios* (Information Paper, July 2017), available at: <https://www.apra.gov.au/information-papers-released-apra>.

<sup>3</sup> APRA, *Revisions to the capital framework for authorised deposit-taking institutions* (Discussion Paper, February 2018), available at: <https://www.apra.gov.au/implementing-basel-iii-capital-reforms-australia>.

This paper deals with the third objective, setting out potential options to improve the transparency, comparability and flexibility of the capital framework.

**Figure 1** *Revisions to the ADI capital framework*



**Importantly, the proposals in this paper are not intended to change the quantum or allocation of capital.** Rather, this paper commences consultation on potential approaches to improve transparency, comparability and flexibility of the ADI capital framework. These approaches, which are summarised below, focus on amending disclosure requirements and the way in which ADIs would be required to calculate and report capital ratios, without altering the quantum and risk sensitivity of capital requirements.

APRA is considering two conceptual approaches, which may be applied individually or in combination, to improve transparency and comparability of ADI capital ratios:

- Under the first approach, APRA would specify a methodology to quantify certain aspects of relative conservatism within the ADI capital framework. This methodology would be used to estimate internationally comparable capital ratios for disclosure purposes only. This approach would be subject to mandatory reporting requirements and, for ADIs using the internal ratings-based (IRB) approach to credit risk (IRB ADIs), mandatory disclosure requirements.

- Under the second approach, some aspects of relative conservatism within the definition of capital and calculation of risk-weighted assets (RWA) would be modified so that ADI capital ratios would be calculated on a more internationally harmonised basis. To maintain the strength and risk sensitivity of the capital framework, there would be corresponding increases in minimum capital ratio and/or capital buffer requirements. These increases, which would be specific to each ADI, would be based on the data reported to APRA and, for IRB ADIs, subject to mandatory disclosure requirements.

APRA remains open to retaining the current methodology (i.e. not implementing either approach) for some or all aspects of relative conservatism, particularly if it is concluded that the benefits of improved transparency and comparability of ADI capital strength do not outweigh the increase in complexity and associated regulatory burden. APRA invites feedback on the relative merits of these approaches.

Regardless of the approach(es) adopted, APRA is also considering measures to make the capital framework more flexible in times of stress. These measures include increasing the size of the Capital Conservation Buffer relative to the size of the minimum Prudential Capital Requirement and potential changes to the point of automatic regulatory interventions. Such realignment of regulatory capital ratios would enhance supervisory flexibility in times of financial or economic stress, either at an individual ADI level or for the banking system as a whole. It may also enhance the usability of capital buffers held by ADIs to manage their capital positions during periods of stress.

APRA intends to consult on draft revised prudential standards incorporating the outcome of this consultation in 2019. Further APRA intends to progress any aspects set out in this Discussion Paper that it proposes to adopt in parallel with the revisions to the ADI capital framework outlined in the February 2018 Discussion Paper.

# Glossary

<b>Additional Tier 1 (AT1) capital</b>	Capital instruments that provide loss-absorption while the ADI remains a going concern, but do not satisfy all of the criteria for inclusion in Common Equity Tier 1 capital (see <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i> )
<b>ADI</b>	Authorised deposit-taking institution
<b>APRA</b>	Australian Prudential Regulation Authority
<b>Basel capital framework</b>	The internationally agreed capital framework for banks developed by the Basel Committee on Banking Supervision
<b>Basel Committee</b>	Basel Committee on Banking Supervision
<b>Basel III</b>	<p>A series of revisions to the Basel capital framework following the global financial crisis that commenced with the Basel Committee on Banking Supervision's <i>Basel III: A global regulatory framework for more resilient banks and banking systems</i>, December 2010 (revised June 2011) and includes the following reforms:</p> <ul style="list-style-type: none"> <li>• <i>Basel III: Finalising post-crisis reforms</i>, December 2017, which includes revisions to the frameworks for credit risk, credit valuation risk and operational risk, and introduces a floor on RWA using the standardised approaches and a non-risk-based minimum leverage requirement;</li> <li>• <i>Minimum capital requirements for market risk</i>, January 2016; and</li> <li>• <i>Interest rate risk in the banking book</i>, April 2016.</li> </ul>
<b>CCB</b>	Capital conservation buffer (see <i>Prudential Standard APS 110 Capital Adequacy</i> )
<b>CCF</b>	Credit conversion factor
<b>CCyB</b>	Countercyclical capital buffer (see <i>Prudential Standard APS 110 Capital Adequacy</i> )
<b>CET1 ratio</b>	Common Equity Tier 1 capital divided by total risk-weighted assets
<b>Common Equity Tier 1 (CET1) capital</b>	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 (see <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i> )
<b>D-SIB</b>	Domestic systemically important bank
<b>FSI</b>	Financial System Inquiry

<b>IRB ADI</b>	An ADI with approval from APRA to adopt the internal ratings-based approach to credit risk to determine its capital adequacy requirements
<b>IRRBB</b>	Interest rate risk in the banking book (see <i>Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)</i> )
<b>LGD</b>	Loss given default
<b>Loss absorption trigger point</b>	The point at which an ADI's Additional Tier 1 capital instruments that are classified as liabilities under Australian Accounting Standards, are either written off, or converted into Common Equity Tier 1 capital. The point is reached when an ADI's CET1 ratio falls to, or below 5.125 per cent of RWA (see <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i> )
<b>PCR</b>	Prudential capital requirement (see <i>Prudential Standard APS 110 Capital Adequacy</i> )
<b>QIS</b>	Quantitative Impact Study
<b>RWA</b>	Risk-weighted assets
<b>Standardised ADI</b>	An ADI that has not been granted approval from APRA to adopt the internal ratings-based approach and uses the standardised approach to credit risk for determining its capital adequacy requirements
<b>Tier 1 capital</b>	The sum of Common Equity Tier 1 capital and Additional Tier 1 capital (see <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i> )
<b>Total capital</b>	Total capital as defined in <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i>

# Chapter 1 – Introduction

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## 1.1 Background

The Australian Prudential Regulation Authority (APRA) has always regarded compliance with internationally agreed prudential standards to be in the interests of the Australian financial system; this is critical to ensuring the attractiveness of regulated institutions to the providers – particularly from offshore – of debt funding and capital. This approach has been endorsed and supported by major inquiries into the financial system, including the Wallis Inquiry (1997) and the Murray Inquiry (2014).<sup>4</sup>

For the banking industry, the international prudential standard setter is the Basel Committee on Banking Supervision (Basel Committee). APRA therefore seeks to apply Basel Committee standards to Australian authorised deposit-taking institutions (ADIs), wherever appropriate.

The capital adequacy framework that APRA applies to ADIs in Australia is founded on the internationally agreed and well understood framework for measuring bank capital adequacy that the Basel Committee first established in 1988. The latest version of the Basel capital framework is commonly known as Basel III, and was developed in response to the global financial crisis.<sup>5</sup> Under the Basel capital framework, an ADI's risk-based capital adequacy ratios, which are calculated by dividing its regulatory capital by total risk-weighted assets (RWA), must exceed specified minima.

In implementing the Basel capital framework in Australia, APRA has traditionally adopted a more conservative approach than the internationally agreed minimum requirements. Two principles underpin APRA's longstanding approach: (i) assets that rely on the future profitability of the ADI to be realised, or that are highly uncertain in value, cannot be included in the calculation of capital; and (ii) capital cannot be used more than once in the financial system to absorb losses. In addition, APRA has used national discretions available within the Basel capital framework to tailor the capital treatment, including the determination of RWA, of certain items to reflect its assessment of Australian conditions and risks.

As a result, APRA's capital requirements for Australian ADIs are commonly acknowledged as more conservative than is often applied in other jurisdictions, thereby providing additional support for ADIs' depositors and other creditors. Unlike some other jurisdictions which have applied conservatism to their own capital requirements through higher minimum capital ratio requirements, APRA has to date applied conservatism through targeted measures that strengthen the definition of capital and determination of RWA. APRA's approach is intended not just to produce an adequate level of capital, but also to ensure that capital better corresponds to the risks that it is designed to support.

<sup>4</sup> Financial System Inquiry, *Final Report* (March 1997); Financial System Inquiry, *Final Report* (November 2014).

<sup>5</sup> Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (December 2017), available at: <https://www.bis.org/bcbs/publ/d424.htm>.

While APRA's framework improves the quality and effectiveness of domestic capital requirements, it has two potential drawbacks:

- It may complicate international comparisons of capital strength. In particular, the reported capital ratios of Australian ADIs will tend to look lower than those of international peers. This potentially makes it more difficult or costly for ADIs to access international capital markets if these Australian differences are not well understood, particularly during times of market dislocation.
- The more conservatively calculated capital ratios of ADIs are closer to the Basel capital framework minimum ratios and 'triggers' (e.g. the 'non-viability' trigger) than those of banks in other jurisdictions. This potentially hinders an ADI's and APRA's flexibility in dealing with stress situations.

## 1.2 APRA's capital framework

### 1.2.1 Differences between the standardised and IRB approaches

Consistent with the Basel capital framework, Australia's capital adequacy framework allows two approaches to determining RWA for credit risk regulatory capital requirements:

- The standardised approach uses a prescribed set of risk weights to reflect the risks of different asset classes. These are not tailored to a specific ADI and are set at a level to ensure adequate capitalisation on average across portfolios and ADIs of differing risk characteristics.
- The internal ratings-based (IRB) approach permits, subject to APRA approval, an ADI to use its own internal models and experience data to assess risk at a more granular level, and measure risk weights accordingly. Achieving APRA's approval to use the IRB approach requires an ADI to have a strong and sophisticated risk management framework and capacity.

The IRB approach is more risk sensitive and aims to more precisely align risk and capital, compared to the standardised approach, which uses benchmark risk weights to ensure an appropriate level of capital adequacy. The IRB approach also requires capital to be held for broader risk types, for example, interest rate risk in the banking book (IRRBB); and is generally more suited to ADIs with greater risk management capability, scale, and diversified business models.

The inclusion of two different approaches to the measurement of capital adequacy, by allowing for the use of more granular risk weights where supported by strong risk management and measurement capabilities, serves to improve the risk sensitivity of the capital framework where possible. This should in turn improve the efficiency of capital allocation in the banking sector. However, it will also mean that the capital ratios of ADIs using the standardised approach (standardised ADIs) and those using the more risk sensitive IRB approach (IRB ADIs) are not strictly comparable. Given the standardised approach is calibrated more conservatively to take account of its relative simplicity, an ADI's capital ratios will tend to be higher under the IRB approach than the standardised approach.

## 1.2.2 Relative conservatism within APRA's current capital framework

APRA's July 2015 international capital comparison study identified aspects of relative conservatism within the capital framework and detailed the comparative capital adequacy position of Australia's four largest ADIs against a set of global peers, using a range of measures of capital strength.<sup>6</sup>

In the 2015 study, the most material aspects of relative conservatism in the definition of regulatory capital were in respect of capital deductions for:

- investments in other financial institutions;
- deferred tax assets arising from timing differences;
- investments in commercial entities;
- capitalised expenses and transaction costs; and
- holdings of subordinated tranches of securitisations.

Although the study focussed specifically on the four largest ADIs, who all use the IRB approach to credit risk, these differences also apply to ADIs using the standardised approach.

The most material aspects of relative conservatism in the determination of RWA under the IRB framework were as follows:

- the 20 per cent loss given default (LGD) portfolio constraint required for residential mortgage exposures;
- the capital requirement for IRRBB, which is not included in the Basel capital framework's minimum requirements;
- the LGD parameter for unsecured non-retail exposures;
- credit conversion factors (CCFs) for undrawn non-retail commitments;
- use of supervisory slotting and the scaling factor for specialised lending;
- risk weights for other retail exposures covered by the standardised approach to credit risk; and
- the exchange rate used to convert Euro-denominated thresholds in the Basel capital framework into Australian dollars.

Since the 2015 study, APRA has introduced additional conservatism into the IRB framework through the upward adjustments to the IRB risk weight calculation for residential mortgages.

<sup>6</sup> See APRA, *International capital comparison study*, (Information Paper, July 2015) for more detail, available at: <https://www.apra.gov.au/information-papers-released-apra>.

This was instituted in response to a recommendation of the 2014 Financial System Inquiry (FSI), and came into effect from 1 July 2016.<sup>7</sup>

Table 1 below provides an indicative quantification of the effect of the relative conservatism in APRA's current framework in terms of the average CET1 capital ratio for the four largest ADIs as at June 2017.<sup>8</sup> At that time, the average increase in the CET1 capital ratio due to APRA's relative conservatism for the four largest ADIs was in the order of 485 basis points.

**Table 1** *Estimated adjustments to achieve internationally comparable CET1 capital ratios – average over the four largest ADIs as at June 2017*

Average over the four largest ADIs as at June 2017	CET1 capital ratio impact (basis points)
Relative conservatism within the definition of capital	130
Other aspects of relative conservatism in the determination of RWA in the IRB framework	270
Upward adjustments to the IRB residential mortgage risk weight function, introduced from 1 July 2016	85
<b>Total</b>	<b>485</b>

Relative to the IRB approach, the standardised approach to credit risk provides for a simpler approach for the determination of RWA. Under APRA's standardised approach to credit risk, APRA has applied its national discretion in two material areas:

- the use of a risk-weighting scheme for residential mortgage exposures based on the loan-to-valuation ratio of the loan, rather than a flat 35 per cent risk weight.<sup>9</sup> APRA's risk-weight scheme also differentiates according to whether the loan has acceptable lenders mortgage insurance coverage and whether the loan is a 'standard' or 'non-standard' residential mortgage loan; and
- the application of a 100 per cent risk weight for 'other retail' exposures rather than applying a 75 per cent risk weight.

APRA's conservative approach to capital adequacy for the residential mortgage and other retail lending portfolios within the standardised approach would generate, all else equal,

<sup>7</sup> This change was announced in July 2015 and represented APRA's interim response to Recommendation 2 of the Financial System Inquiry (2014) that APRA raise the average IRB mortgage risk weight to narrow the difference between IRB and standardised risk weights. See <https://www.apra.gov.au/media-centre/media-releases/apra-increases-capital-adequacy-requirements-residential-mortgage>.

<sup>8</sup> The latest comprehensive quantitative impact study undertaken was based on data as at June 2017. APRA expects that more recent calculations would not be materially different from the figures presented in Table 1.

<sup>9</sup> Under APRA's standardised approach, the average risk weight for residential mortgages is approximately 38 per cent as at June 2017.

lower reported capital ratios for standardised ADIs compared to international peers with comparable portfolios.<sup>10</sup>

### 1.2.3 Impact of proposed revisions to the ADI capital framework

In response to Recommendation 1 of the FSI, APRA issued an Information Paper in July 2017 that set out its estimates of the amounts by which domestic capital requirements would need to be raised to achieve 'unquestionably strong' capital ratios.<sup>11</sup> APRA then released a discussion paper in February 2018 that outlined proposed revisions to risk-based capital requirements for ADIs for credit, market and operational risks.<sup>12</sup>

Key changes include:

- higher correlation factors used within the IRB risk weight calculation for residential mortgages and commercial property exposures;
- higher supervisor-provided estimates for LGD under the foundation IRB approach for some exposures;
- higher CCFs under both the standardised and IRB approaches for some exposures;
- different IRB asset class classifications compared with Basel III classifications, with the removal of qualifying revolving retail exposures and retail small- and medium-sized enterprise (SME) exposures; and
- higher risk weights for some residential mortgage exposures and some retail exposures under the standardised approach.

APRA is undertaking further quantitative analysis to ensure that the final calibration of the revised framework meets the 'unquestionably strong' benchmarks set out in the July 2017 Information Paper. It is therefore not currently possible to quantify the impacts of those proposals until the results of APRA's quantitative impact study (QIS) have been assessed and the calibration of the framework has been determined. The risk weights detailed in the February 2018 Discussion Paper should therefore be regarded as indicative only. For IRB ADIs in particular, APRA expects that these indicative risk weights will not by themselves meet the 'unquestionably strong' benchmarks, so an additional overlay may be necessary.

However, it is clear that these proposed revisions will, if implemented, further increase the overall level of relative conservatism in both the IRB and standardised credit risk frameworks to achieve the 'unquestionably strong' aspiration set by the FSI, as well as change where that conservatism resides within the framework.

<sup>10</sup> The impact on standardised ADIs' reported CET1 ratios varies considerably by ADI; averaged across all standardised ADIs, the impact on reported CET1 ratios is estimated to be between 100 and 150 basis points.

<sup>11</sup> APRA, *Strengthening banking sector resilience: establishing unquestionably strong capital ratios* (Information Paper, July 2017), available at: <https://www.apra.gov.au/information-papers-released-apra>.

<sup>12</sup> APRA, *Revisions to the capital framework for authorised deposit-taking institutions* (Discussion Paper, February 2018), available at: <https://www.apra.gov.au/implementing-basel-iii-capital-reforms-australia>.

### **Risk-weighted asset floor for the IRB approach**

APRA has proposed that, consistent with Basel III, it will introduce a floor to minimum RWA for IRB ADIs. This floor will limit the ability of internal models to generate capital outcomes that vary from prescribed standardised risk weights beyond a maximum threshold. While the disclosure requirements in relation to the floor have not been finalised by the Basel Committee, IRB ADIs are likely to be required to disclose RWA on both the IRB and standardised bases.

The disclosure of standardised RWA will improve transparency of risk weight outcomes between the IRB and standardised approaches and will enhance domestic comparability across ADIs. To the extent that the Basel III RWA floor is consistently implemented across jurisdictions, this will also enhance international transparency and comparability of capital strength across international peer banks.

However, there are limitations on the extent to which the disclosure of a standardised floor may enhance either domestic or international comparability:

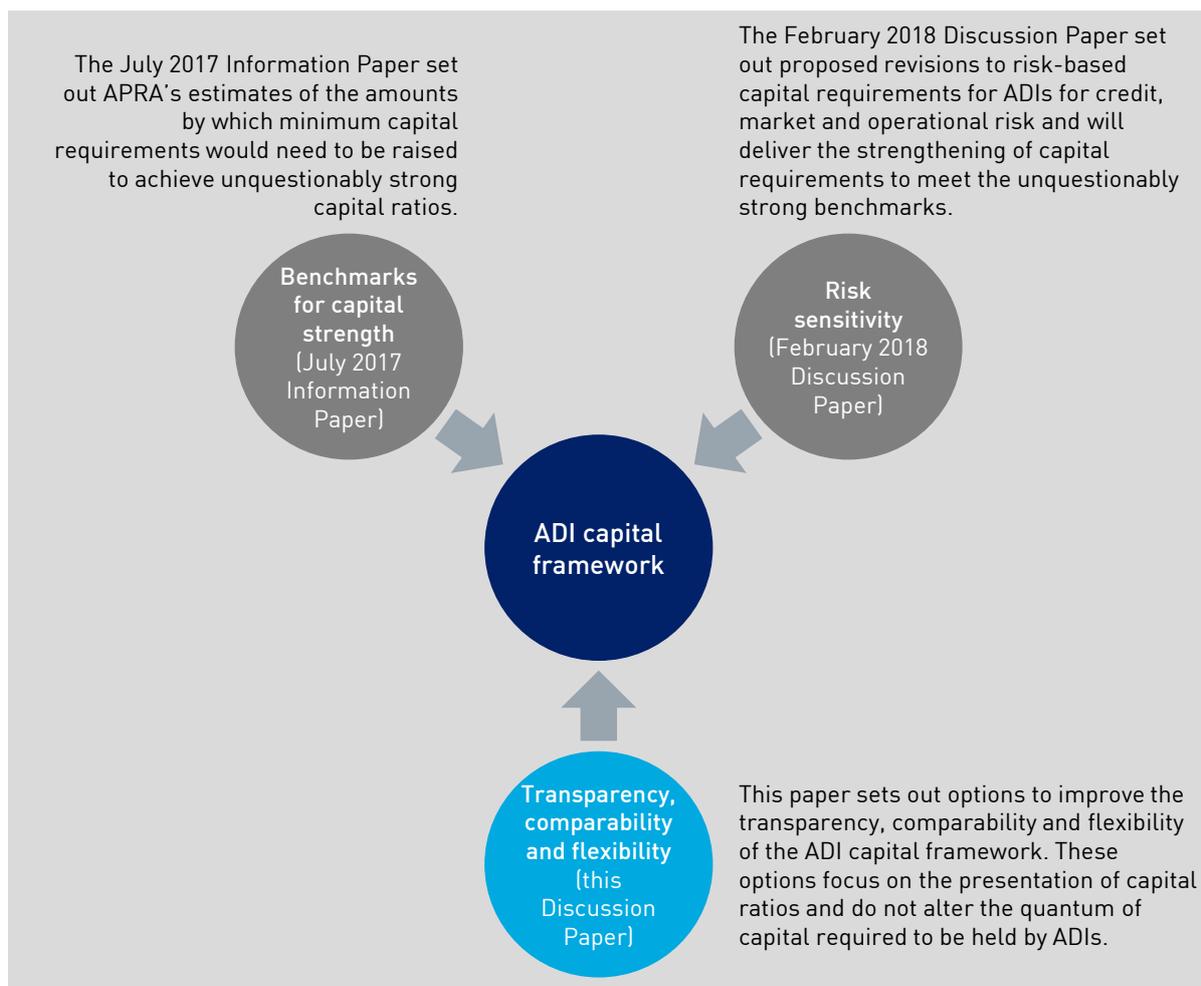
- Compared to the standardised approach, the IRB approach allows the capital outcome to be more risk sensitive and more tailored to each ADI, and to the conditions within each jurisdiction.
- International comparability may be further limited by the extent to which APRA and other jurisdictions have applied national discretion in the determination of RWA under the standardised approach.

## **1.3 Objectives of the revisions to the capital framework**

In reviewing the current capital framework, APRA is pursuing three principal objectives:

- **the quantum of capital** - to achieve an overall level of capital that meets the 'unquestionably strong' aspiration set by the FSI;
- **the allocation of capital** - to improve the risk sensitivity of current capital requirements, where possible, by more appropriately aligning capital requirements to underlying risks; and
- **the comparability of capital** - to improve the transparency, comparability and flexibility of the capital framework where possible, without materially jeopardising either of the other two objectives. APRA also seeks to avoid measures that would introduce undue complexity into the ADI capital framework.

Recognising the interdependencies between changes to the risk-based capital framework and measures to improve transparency and comparability, APRA intends to progress these reforms in parallel. The following figure summarises APRA's approach to revisions of the ADI capital framework.



## 1.4 Achieving transparency, comparability and flexibility

### 1.4.1 Transparency

Transparency is a core component of the Basel capital framework via its disclosure requirements (known as 'Pillar 3' of the framework).<sup>13</sup> These requirements seek to aid market discipline on bank risk taking via the provision of information about common key risk metrics to market participants. Pillar 3 is intended to reduce information asymmetry and help promote comparability of banks' risk profiles within and across jurisdictions.

APRA's preference is that, wherever possible, the strength and risk sensitivity of its capital framework is sufficiently transparent. This includes examining ways that domestic adjustments to internationally agreed minimum requirements could be easier to identify and account for. Improved transparency would enable greater understanding of capital strength and risk sensitivity, facilitating market discipline, including during times of financial stress.

<sup>13</sup> The other two pillars of the framework are the minimum capital requirements themselves (Pillar 1); and the supervisory review process (Pillar 2).

## 1.4.2 Comparability

Comparability, together with transparency, facilitates a greater understanding of relative capital strength. Given the reliance of the Australian financial system, and therefore the broader economy, on funding sourced from overseas by the banking system, there may be benefits to improving the ability of investors, particularly from offshore, to better compare the relative capital strength of Australian ADIs with their international peers. This improved comparability may reduce the risk of any undue interruption to the flow and cost of funding to the financial system.

While the Basel capital framework establishes internationally agreed minimum requirements, it also includes national discretions in a number of areas. As is the case in Australia, these have been exercised by many jurisdictions to suit their individual circumstances. Even though Australian ADIs are required to disclose information in accordance with the principles of Pillar 3, currently the degree of relative conservatism within APRA's capital framework is not readily apparent to many investors or other market participants. While certain informed stakeholders, such as the key credit rating agencies, have analysed and given consideration to the differences as part of their credit assessments, that degree of analysis will not be warranted by others who may wish to rely simply on published material.

In seeking to address this, some larger ADIs have begun publishing an 'internationally comparable' CET1 capital ratio that is estimated based on the adjustments described in APRA's 2015 international capital comparison study.<sup>14</sup> The publication by APRA of its own methodology, which has been adopted by the large ADIs, seems to have improved comparability somewhat. However, as noted by the FSI, there are potential impediments to market credibility of these comparative capital ratios that could arise from self-selection of disclosed items and self-reporting of internationally comparable ADI capital ratios.<sup>15</sup>

As discussed above, the RWA floor, contingent on its implementation, may also reflect each jurisdiction's capital adequacy framework rather than being calculated under the minimum capital adequacy framework established by the Basel Committee.

Taken together, these factors mean that there is no single basis of measurement on which to easily compare all banks internationally. APRA is therefore considering how to improve the comparability of ADI capital ratios, to the extent reasonably practicable.

## 1.4.3 Flexibility

Improved flexibility within the capital framework would enhance supervisory flexibility in times of financial stress, either at an individual ADI level or for the banking system as a whole. For Australian ADIs, a potential breach of a minimum capital or buffer requirement, and therefore automatic regulatory intervention or restriction, occurs at a higher capital level in dollar terms than those of a number of peer jurisdictions. This may have the potential to

<sup>14</sup> See APRA, *International capital comparison study*, (Information Paper, July 2015) for more detail, available at <https://www.apra.gov.au/information-papers-released-apra>.

<sup>15</sup> Financial System Inquiry, *Final Report* (November 2014), p77.

reduce APRA's flexibility, particularly in times of stress, in terms of the timing and type of action that could be taken.

APRA is therefore examining ways to enhance the flexibility of the banking system's ability to respond and adjust when faced with adversity, to enable sound ADIs to continue to lend and provide other critical economic functions.

## **1.5 Outline of this consultation**

With this Discussion Paper, APRA is commencing consultation on potential approaches to improve transparency, comparability and flexibility of ADI capital ratios and requirements.

Chapter 2 outlines the possible approaches to modifying the ADI capital framework to improve transparency and comparability of capital ratios, including an assessment of advantages and challenges, and indicative examples.

Chapter 3 outlines possible options to enhance supervisory flexibility with respect to capital requirements in times of financial stress, either at an individual ADI level or for the banking system as a whole.

The measures outlined in this Discussion Paper do not propose any further revision to risk-based capital requirements for ADIs, which were outlined in APRA's February 2018 Discussion Paper.

APRA intends to consult on draft revised prudential standards incorporating the outcome of this consultation in 2019. Further information on next steps is set out in Chapter 4.

## 1.6 Balancing APRA's objectives

APRA's mandate is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, and in balancing these objectives, to promote financial system stability in Australia.

On balance, APRA considers that the proposals in this Discussion Paper have the potential to support the financial safety of ADI depositors and promote financial system stability.

PRIMARY OBJECTIVES	
<b>Financial safety</b> 	<b>Financial system stability</b> 
<p><b>Marginally improved:</b> the increased comparability and transparency of the ADI capital framework supports the 'unquestionably strong' objective that the actual capital strength of ADIs should be perceived as such.</p>	<p><b>Improved:</b> the approaches improve the ability of APRA to respond to situations of stress and reduce the likelihood of any undue interruption to the flow and cost of funding of the financial system.</p>
OTHER CONSIDERATIONS	
<b>Efficiency</b> 	<p><b>Marginally reduced:</b> the approaches may increase complexity and associated regulatory burden for some ADIs.</p> <p>However, more transparent and internationally comparable ADI capital ratios may improve ADI access to international funding markets.</p>
<b>Competition</b> 	<p><b>No material change:</b> no likely impact on the competitive landscape (noting that any increased regulatory burden would primarily fall on large ADIs). However, improved understanding of the comparative capital strength of IRB ADIs against standardised ADIs may enhance domestic market discipline.</p>
<b>Contestability</b> 	<p><b>No material change:</b> the approaches in this paper have no impact on the ability of new entrants to enter the banking industry.</p>
<b>Competitive Neutrality</b> 	<p><b>No material change:</b> the approaches in this paper have no impact on competitive neutrality.</p>

## Chapter 2 – Options to improve transparency and comparability of capital ratios

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APRA is considering options to modify the ADI capital framework to improve transparency and comparability of reported capital ratios. The main conceptual approaches APRA is considering and seeking feedback on are:

- developing more consistent disclosures without modifying the underlying capital framework; and
- modifying the capital framework by adjusting the methodology for calculating capital ratios.

These options are not mutually exclusive, and there is potential for both approaches to be adopted and applied in different areas.

APRA considers there can be benefits for ADIs from enhanced transparency and public understanding of their capital strength. However, achieving these benefits – using either of the broad approaches above – may increase operational complexity in capital management and regulatory reporting burden. Further, as the approaches being contemplated will have a considerably smaller impact on capital ratios for standardised ADIs than for IRB ADIs, APRA is also considering measures that would reduce the regulatory burden of these approaches for standardised ADIs. These measures are outlined in section 2.2.3.

### 2.1 Focus on material items

Regardless of the approach adopted, APRA intends to focus any measures on areas of relative conservatism that are material and can be calculated objectively.

Table 2 below outlines aspects of the capital framework that may meet these criteria. This table includes proposals in the February 2018 Discussion Paper, noting that these aspects may be subject to change reflecting responses to that consultation (see section 1.2.3 for further detail).

**Table 2** Aspects of relative conservatism

<b>Applicable to both IRB and standardised ADIs</b>	<b>Material in size and objectively calculable?</b>
Exposures for which APRA requires a capital deduction rather than risk-weighting (refer to section 1.2 above)	Yes
Any additional overlay needed to recalibrate the proposals in the February 2018 Discussion Paper to ensure that the final calibration of the revised framework meets the 'unquestionably strong' benchmarks	Yes
<b>Applicable to IRB ADIs</b>	<b>Material in size and objectively calculable?</b>
Capital for IRRBB	Yes
Higher correlation factors for residential mortgages and commercial property exposures	Yes
Higher estimates for LGD for some exposures	Yes
Higher estimates for CCFs for some exposures (other commitments)	Yes
Higher residential mortgage LGD estimate	May use a proxy harmonised estimate (e.g. LGD=15%)
Asset class definitions: removing 'Qualifying revolving retail' as a separate asset class and requiring SME to be treated as corporate exposures <sup>16</sup>	No
<b>Applicable to standardised ADIs</b>	<b>Material in size and readily calculable?</b>
Higher risk weights for some exposures under the standardised approach	Yes
The classification of residential mortgage loans as 'owner occupied P&I' and 'other' rather than 'not materially dependent' and 'materially dependent'	No
Higher estimates for CCFs for some exposures (other commitments)	Yes

<sup>16</sup> For commercial property exposures in the SME asset class, APRA proposed that ADIs would apply a commercial property risk-weight function.

## 2.2 Approaches to improving transparency and comparability

### 2.2.1 Approach 1 – Consistent disclosures

Under this approach, ADIs would continue to determine regulatory capital ratios using APRA's definitions of capital and RWA. However, APRA would also specify a methodology for ADIs to determine certain adjustments to capital and RWA that could be used for disclosure (Pillar 3) purposes. As noted above, the methodology would focus on aspects of relative conservatism that are material in size and able to be calculated simply and objectively. The supplementary disclosure would allow all stakeholders to better assess the capital strength of an ADI on a more comparable basis. However, it would result in two APRA-endorsed capital ratios: an APRA regulatory capital ratio to be compared against minimum requirements, and an additional disclosure-only capital ratio for, in particular, international comparison.

The methodology would be included within the reporting framework and subject to the audit testing requirements under *Prudential Standard APS 310 Audit and Related Matters* (APS 310). *Prudential Standard APS 330 Public Disclosure* (APS 330) would be revised to include, at a minimum, disclosure of the aggregate impact of all adjustments. Detailed disclosure of the amount for specific aspects of relative conservatism could also be required to further enhance transparency and comparability. APRA seeks feedback on the most appropriate level of disclosure (i.e. in aggregate and/or by specific aspect of relative conservatism), and on the advantages and challenges of this approach.

### 2.2.2 Approach 2 – Capital ratio adjustments

An alternative approach would involve APRA modifying the calculation of regulatory capital ratios to utilise more internationally harmonised definitions of capital and RWA. This would involve removing certain aspects of relative conservatism from ADIs' capital ratio calculations and lifting minimum regulatory capital ratio requirements in tandem. This increase in regulatory capital ratio requirements could be in the form of a transparent adjustment to minimum capital ratio requirements—for the purposes of this paper, such an adjustment is termed the 'APRA Overlay Adjustment'.

To maintain overall capital adequacy, the APRA Overlay Adjustment would need to be calculated such that the total dollar amount of Prudential Capital Requirement (PCR) and Capital Conservation Buffer (CCB) would be the same as that required if these measures were not adopted. In other words, the risk-based capital requirements of ADIs would be unchanged in absolute dollar terms, maintaining financial safety, but adjustments to the numerator and the denominator of the capital ratio to be more internationally comparable would increase reported capital ratios. Further discussion on the allocation of the APRA Overlay Adjustment among PCR and CCB is set out in section 3.1.

In practice, an APRA Overlay Adjustment would be required for each tier of capital, namely CET1, Tier 1 and Total capital. For simplicity, this Discussion Paper focuses on CET1 capital.

An ADI's APRA Overlay Adjustment would be risk sensitive and therefore ADI-specific, and would vary over time to reflect changes in risk profile. Although capital requirements naturally vary in dollar terms over time, under this approach ADIs would also need to allow

for variability in capital ratio requirements in their capital management. This may increase operational complexity for some ADIs.

As an option to reduce operational complexity, the APRA Overlay Adjustment could be recalculated on a periodic basis. For example, it could occur on an annual basis (rather than the quarterly basis on which capital ratios are currently disclosed), and rounded up, such as to the nearest 25 basis points. If implemented, the less frequent and rounded calculation of the APRA Overlay Adjustment would be expected to marginally reduce the framework's risk sensitivity. APRA seeks feedback on the potential complexity arising from a variable capital ratio requirement, including impacts on ADIs' strategic, business and capital planning.

Similar to Approach 1, Approach 2 could apply to aspects of relative conservatism that are material in size and able to be calculated simply and objectively. ADIs would be subject to reporting requirements and the audit testing requirements under APS 310. At a minimum, the aggregate amount of the APRA Overlay Adjustment would be subject to disclosure requirements under a revised APS 330. Additionally, the elements comprising the calculation of the APRA Overlay Adjustment could also be subject to disclosure requirements. This would result in a transparent increase in minimum capital and regulatory buffer ratio requirements.

APRA would, however, continue to reserve the right to impose ADI-specific adjustments to PCR where appropriate, which would continue to not be disclosable.

### **2.2.3 Simplifications for standardised ADIs**

The magnitude of adjustments under Approach 1 and Approach 2 would typically be considerably smaller for standardised ADIs when compared to IRB ADIs. Nevertheless, conceptually these approaches can be applied to all ADIs. APRA considers that if Approach 2 is applied to the definition of capital, it would be appropriate to apply the same approach to all ADIs.

Further, APRA seeks feedback on the following measures that may be introduced to reduce the regulatory burden for standardised ADIs:

- the APRA Overlay Adjustment under Approach 2 could be recalculated on a less frequent basis;
- the adjustments under Approach 1 and Approach 2 could be generated as part of the ADI's normal APRA regulatory reporting process and would be expected to be largely automated; and
- disclosure could be voluntary.

## 2.2.4 Advantages and challenges arising from the approaches

The advantages and challenges of both approaches are outlined in the table below.

**Table 3** *Advantages and challenges*

	Advantages	Challenges
<b>Approach 1: consistent disclosures</b>	<ul style="list-style-type: none"> <li>• Simpler approach as it does not involve changes to any regulatory capital requirements.</li> <li>• Improves transparency of items to which APRA has applied relative conservatism.</li> <li>• Builds on the existing practice of larger ADIs self-disclosing comparable capital ratios, and adds credibility as the methodology would be determined by APRA.</li> <li>• Lowest cost of the two possible approaches.</li> </ul>	<ul style="list-style-type: none"> <li>• Results in two APRA-endorsed capital ratios for ADIs (one which is a regulatory requirement and one which is a disclosure-only measure) which may create confusion.</li> <li>• Investors may still focus on the regulatory ratios rather than the notionally adjusted ratios.</li> </ul>
<b>Approach 2: capital ratio adjustments</b>	<ul style="list-style-type: none"> <li>• Improves transparency of items to which APRA has applied relative conservatism.</li> <li>• More effective approach to improving comparability through adjustments to regulatory capital ratios. Supports the 'unquestionably strong' objective that actual capital strength should be perceived as such.</li> <li>• Provides opportunity to increase the responsiveness of the ADI capital framework in times of stress (refer to Chapter 3).</li> </ul>	<ul style="list-style-type: none"> <li>• Involves changes to both capital and disclosure requirements.</li> <li>• May significantly increase operational complexity for ADIs - the application of the APRA Overlay Adjustment would result in a variable capital ratio requirement.</li> <li>• Introduction of variability in minimum capital requirements introduces complexity in analysing capital buffers and may undermine desired transparency.</li> <li>• The appropriateness of the loss absorption trigger point of 5.125 per cent of RWA will need to be reviewed (refer to Chapter 3).</li> </ul>

## 2.2.5 Summary

Table 4 below summarises the two conceptual approaches:

**Table 4** *Summary of approaches*

<b>Approach 1 – consistent disclosures</b>	APRA would specify adjustments to reported capital and RWA to enable more credible disclosure of ADI internationally comparable capital ratios without changing the definitions of capital and RWA.
<b>Approach 2 – capital ratio adjustments</b>	APRA would adopt more internationally harmonised definitions of capital and RWA. The resultant increase in capital ratios would be offset by an increase in individual ADI regulatory capital ratio requirements.

Taking into account submissions received in response to this Discussion Paper, there is potential for APRA’s revised capital framework to include elements of Approach 1 and Approach 2 applying to different aspects of relative conservatism, as well as maintaining APRA’s current approach in other areas.

However, it is not intended that the choice of approach be optional for individual ADIs. It is critical to transparency and comparability that a plethora of capital approaches does not emerge from any changes made.

Further, the approaches outlined in this chapter are intended to not materially affect the risk sensitivity and overall calibration of the capital framework, but instead focus on improving transparency and comparability of reported capital ratios.

## 2.3 Indicative examples

This section provides examples of the two approaches outlined above.

For illustrative purposes, the examples use two of the more material areas where APRA applies a more conservative approach than the internationally agreed minimum requirements of the Basel capital framework:

- capital requirements for IRRBB; and
- the proposed mortgage correlation factor changes for IRB ADIs’ residential mortgage exposures.

To keep the examples simple, only the impact on CET1 capital ratios is presented.

### 2.3.1 Interest rate risk in the banking book

APRA requires IRB ADIs to hold capital for IRRBB through higher RWA within minimum capital requirements rather than the more common international practice of supervisory adjustments. As a result, APRA’s approach to IRRBB produces lower capital ratios than other jurisdictions.

Table 5 below sets out the assumptions used in this example, which assumes an average IRB ADI that needs to meet a CET1 requirement of 8 per cent,<sup>17</sup> and currently meets the 'unquestionably strong' benchmark for IRB ADIs. In this example, RWA for IRRBB total \$15 billion.

**Table 5** IRRBB example

Capital and RWA (\$m)		Current capital ratios (%)		Current capital requirements (%)	
CET1 capital	42,525	CET1 ratio	10.5%	CET1 PCR	4.5%
Tier 1 capital	51,000	Tier 1 capital ratio	12.6%	Tier 1 PCR	6.0%
Total Capital	60,000	Total Capital ratio	14.8%	Total Capital PCR	8.0%
Total RWA	405,000			Capital conservation buffer (CCB)	3.5%
<i>Of which, IRRBB RWA</i>	15,000				

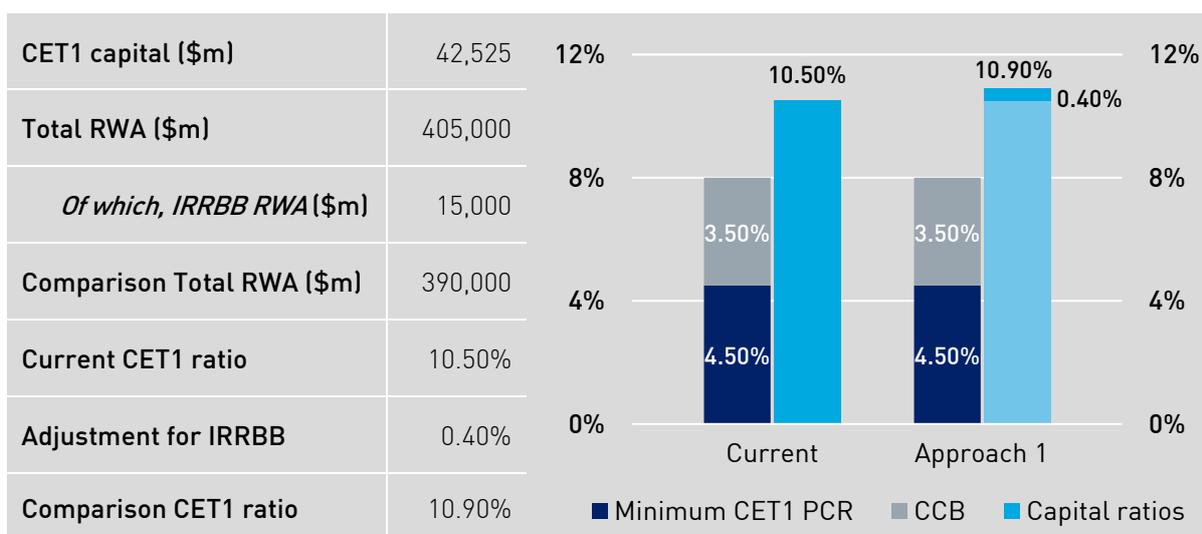
### Approach 1 – consistent disclosures

Under Approach 1, IRB ADIs would continue to include IRRBB in their calculation of regulatory RWA and corresponding regulatory capital ratios. IRB ADIs would also disclose the uplift in capital ratios that would result from removing IRRBB RWA from total RWA. This is done by revising the denominator of the capital ratio calculation to reflect a lower total RWA:

$$(1) \quad \text{Adjustment for IRRBB (\%)} = \frac{\text{Capital measure}}{\text{RWA}_{\text{Total excl. IRRBB}}} - \frac{\text{Capital measure}}{\text{RWA}_{\text{Total}}}$$

<sup>17</sup> The 8 per cent requirement is derived from a minimum CET1 ratio of 4.5 per cent, a CCB of 2.5 per cent, and an additional 1 per cent add-on to the CCB as a result of being designated as a domestic systemically important bank (D-SIB).

Figure 2 Indicative example of IRRBB under Approach 1



As shown in Figure 2, the adjustment for IRRBB results in a more internationally comparable CET1 ratio of 10.90 per cent, which is 40 basis points higher than the regulatory CET1 ratio.

Under Approach 1, in addition to disclosing the regulatory CET1 ratio, ADIs would disclose:

- the quantitative elements where APRA has differed from the Basel capital framework (RWA adjustment of \$15,000m); and
- the comparable CET1 ratio resulting from applying the APRA-specified methodology to estimate adjustments (10.90 per cent).

### Approach 2 – Capital ratio adjustments

Under Approach 2, IRB ADIs would not include IRRBB in their calculation of RWA and corresponding capital ratios. A commensurate adjustment would instead be made to capital ratio requirements (PCR+CCB) to maintain an equivalent dollar level of capital which ensures appropriate capital adequacy. This adjustment is given by the following equation:

$$(2) \quad \text{APRA Overlay Adjustment (\%)} = \frac{(\text{PCR} + \text{CCB})_{\text{CET1}} (\%) \times \text{RWA}_{\text{adjustment}} (\$)}{\text{RWA}_{\text{new headline}} (\$)}$$

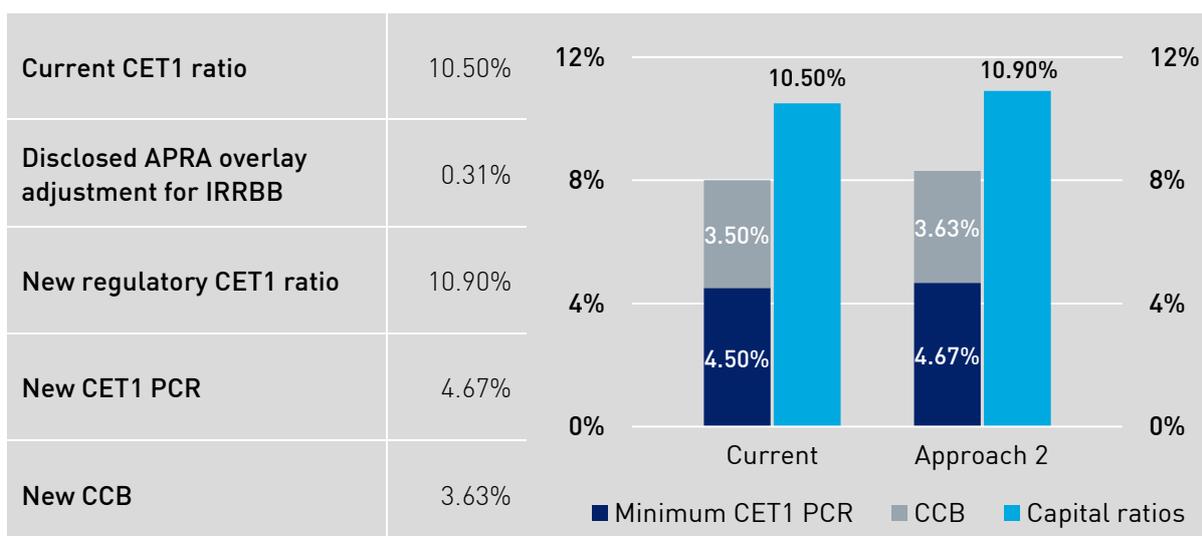
$$\text{Where } \text{RWA}_{\text{new headline}} = \text{RWA}_{\text{old headline}} - \text{RWA}_{\text{adjustment}}$$

Using the data provided in Table 5 above, the recalculated regulatory capital ratios and revised PCR and CCB requirements are set out below, where  $\text{RWA}_{\text{adjustment}}$  is equal to IRRBB RWA. This is shown in Figure 3 below.

$$\text{APRA Overlay Adjustment (\%)} = \frac{8\% \times 15 \text{ billion}}{390 \text{ billion}} = 0.31\%$$

If the allocation of the overlay to the PCR and CCB were to be consistent with APRA's existing framework, it would be based on the allocation of CET1 capital requirements of a 4.5 per cent PCR and a 3.5 per cent CCB. Hence, 56 per cent of the overlay would be allocated to the PCR and 44 per cent to the CCB (as per Figure 3 below).

**Figure 3** Indicative example of IRRBB under Approach 2



Under Approach 2, ADIs would disclose the regulatory CET1 ratio of 10.90 per cent, which would also be used for prudential reporting and compliance, and the APRA Overlay Adjustment of 0.31 per cent.

### 2.3.2 Example of harmonising risk weight calculations

APRA’s February 2018 Discussion Paper proposed adjustments to IRB risk-weight functions that are materially different from those under the Basel III framework. Under both approaches in this paper, IRB ADIs would calculate RWA under APRA’s more conservative capital framework and also on a harmonised basis.

In this example, using APRA’s proposals on the risk-weight function for owner-occupied principal and interest residential mortgages, IRB ADIs would calculate RWA using APRA’s proposed correlation function, given by equation (3) below:

$$(3) \quad \text{Correlation (R)} = 0.15 \times \frac{1 - e^{-35PD}}{1 - e^{-35}} + 0.22 \times \frac{1 - (1 - e^{-35PD})}{1 - e^{-35}}$$

The proposed correlation calculation is more conservative than a more harmonised calculation, which applies a flat correlation factor of 0.15.

Under Approach 1, there would be no change in the calculation of regulatory capital ratios, so an ADI would apply (the more conservative) equation (3) for the purposes of calculating regulatory RWA and corresponding regulatory capital ratios. ADIs would apply the flat correlation factor of 0.15 to calculate the comparison RWA. The regulatory RWA, comparison RWA and corresponding capital ratios would be subject to reporting and disclosure requirements.

Under Approach 2, APRA’s prudential requirements for determining RWA would be modified so that an ADI would instead apply the flat factor of 0.15 for the purposes of calculating RWA and corresponding capital ratios. To determine the RWA adjustment, ADIs would also calculate RWA using equation (3). The ensuing difference between the two calculations determines the APRA Overlay Adjustment to be added to the minimum capital ratio

requirement. The recalculated regulatory capital ratio, which includes the APRA Overlay Adjustment, would be subject to reporting and disclosure requirements.

### **2.3.3 Possible simplification – applying scalars to harmonised RWA**

It may be possible to simplify the implementation of Approaches 1 and 2 by modifying the approach to implementing relative conservatism in credit risk functions. For example, instead of applying the correlation curve in equation (3) above, the credit risk weight function for owner occupied principal and interest mortgages could be based on a correlation factor of 0.15, with APRA's relative conservatism achieved by multiplying the RWA for these mortgages by suitably calibrated scalars to apply to all IRB ADIs.

While simplifying the methodology for calculating credit risk weight functions could allow for more direct, and more transparent calculations under Approaches 1 and 2, APRA would need to balance these benefits against the possibility of reduced risk sensitivity.

## Chapter 3 – Increasing the flexibility of APRA’s capital framework

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The ADI capital framework should support the financial system’s ability to respond when faced with adversity, so as to aid sound ADIs to continue to lend and provide other critical economic functions. Regulatory buffer requirements are designed to support the conservation of capital above minimum requirements while also enhancing the capacity of the financial system and individual ADIs to continue to operate effectively during periods of stress.

Given APRA’s relatively conservative approach to measuring capital adequacy, a potential breach of the PCR or CCB, and therefore regulatory interventions, occurs at a higher capital level in dollar terms for Australian ADIs than might be the case in a number of peer jurisdictions. Absent any other compensating factors, this will tend to reduce the relative flexibility of ADIs to absorb losses and continue to operate in times of stress.

This chapter explores the options that APRA is considering to improve the responsiveness of its capital framework in times of stress, including improving the usability of capital buffers for ADIs, and the supervisory flexibility for APRA to act. Some of these options may only be available under a revised capital framework that incorporates Approach 2 outlined in the previous chapter.

### 3.1 Capital buffers

In conjunction with the approaches outlined in Chapter 2, APRA is exploring options that might, without increasing ADIs’ overall capital requirements, increase the size of the CCB relative to the size of the minimum CET1 PCR. As well as enhancing supervisory flexibility for APRA to address capital fluctuations during a period of financial or economic stress, the realignment of regulatory capital ratios would be expected to enhance the usability of capital buffers held by ADIs to manage their capital positions.

#### **Buffer allocation under Approach 2**

A key component of Approach 2 is the addition of an ADI’s APRA Overlay Adjustment to the sum of the minimum CET1 PCR and the CCB.

If Approach 2 is implemented, APRA could consider whether this adjustment should be allocated in proportion to an ADI’s existing CET1 PCR and CCB, which would align most closely with the existing framework. However, an alternative allocation that might enhance the framework’s flexibility would be to allocate the APRA Overlay Adjustment in a way that increases the size of an ADI’s CCB relative to its CET1 PCR (for example, the entire APRA Overlay Adjustment could be implemented as an increase in the CCB, with no adjustment made to the PCR). Regardless of how this allocation is achieved, APRA would seek to ensure that the resulting total PCR and CCB requirement would remain unchanged.

An important consequence of changing the size of the CET1 PCR and CCB in proportional terms would be that the point at which automatic regulatory intervention or restriction

triggers are activated will effectively change. All other things being equal, this approach would increase the 'distance' between going concern capital ratios and automatic regulatory intervention points, increasing the flexibility of the ADI to undertake recovery actions as well as for APRA to undertake supervisory action. Further detail is provided in section 3.2 below.

### **Buffer calibration**

APRA is currently increasing the calibration of the overall ADI capital framework to meet the 'unquestionably strong' benchmarks. As well as (or instead of) increasing various risk weights to achieve higher capital levels, the overall calibration could be achieved in part by increasing the quantum of the CCB, and could be considered separately to the approaches outlined in Chapter 2. This might also allow, if necessary, differential calibration of buffer requirements for IRB and standardised ADIs.

APRA is also exploring the option that the increase in capital buffers may be achieved by increasing the baseline (normal economic times) setting of the countercyclical capital buffer (CCyB) from its default setting of zero.<sup>18</sup> While ensuring that ADIs have an increased level of resilience prior to a period of financial stress, this would allow APRA the flexibility to temporarily set the CCyB below the baseline during a period of financial stress.

## **3.2 Impact of changes on loss absorption trigger point**

As noted, APRA's current approach to defining capital and RWA results in lower capital ratios relative to a more internationally harmonised methodology.

APRA currently requires Additional Tier 1 (AT1) capital instruments classified as liabilities under Australian Accounting Standards to convert to CET1 capital or be written off when an ADI's CET1 ratio falls to or below 5.125 per cent of total RWA (the loss absorption trigger point).

The consequences of implementing Approach 2 would include:

- the loss absorption trigger point would be reduced in dollar terms, as this becomes 5.125 per cent of a smaller total RWA and would therefore be triggered at a lower level of capital strength than it currently does; and
- if some of the APRA Overlay Adjustment is applied to increase the minimum capital requirement, then it may be possible that an ADI's PCR may be higher than 5.125 per cent. This would serve to undermine the purpose of the loss absorption trigger point, which is designed to recapitalise an ADI before it reaches its PCR.

Accordingly, if APRA were to adopt Approach 2, it would need to consider whether to:

<sup>18</sup> The CCyB is a component of APRA's capital buffer framework that is designed to ensure that ADIs build up capital buffers when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk. The baseline setting of CCyB in normal economic times is zero, and the CCyB is 'turned on' where there is a build-up of system-wide risk. This additional buffer can then be released during periods of system-wide stress, to reduce the risk of the supply of credit being impacted by regulatory capital requirements. The CCyB may range from 0 to 2.5 per cent of RWA.

- maintain a prescribed loss absorption trigger point at 5.125 per cent of RWA and thus harmonise its approach with a number of peer jurisdictions; or
- recalibrate the loss absorption trigger point to an appropriate higher level.

International practices on the loss absorption trigger point vary. While some peer jurisdictions allow their banks to voluntarily set a higher trigger point, others have prescribed a higher trigger point. Either of these options could be appropriate under Approach 2 given any increase in minimum capital ratio requirements would be transparently disclosed. APRA is seeking feedback on the implications of altering the loss absorption trigger point under either option, and on the implications of potentially having multiple trigger points in the market for AT1 capital instruments.

## Chapter 4 – Consultation and next steps

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### 4.1 Request for submissions and cost-benefit analysis information

APRA invites written submissions on the proposals set out in this Discussion Paper. Written submissions should be sent to [ADIpolicy@apra.gov.au](mailto:ADIpolicy@apra.gov.au) by 2 November 2018 and addressed to:

General Manager  
Policy Development  
Policy and Advice Division  
Australian Prudential Regulation Authority

#### 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.

#### Request for cost-benefit analysis information

APRA asks that all stakeholders use this consultation opportunity to provide information on the compliance impact of the proposals, and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any changes to compliance costs incurred by businesses as a result of APRA's proposals.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at <https://rbm.obpr.gov.au/>.

APRA requests that respondents use this methodology to estimate costs to ensure the data supplied to APRA can be aggregated and used in an industry-wide assessment. When

submitting their costs assessment to APRA, respondents should include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake due to foreign regulatory requirements or in their ordinary course of business. Attachment A sets out APRA's preliminary analysis of the cost and benefits of each option.

## 4.2 Consultation questions

To assist interested stakeholders in providing feedback on the proposals outlined in this Discussion Paper, APRA offers the following considerations to guide, but not limit, responses:

<b>Question 1</b>	<p>What are the advantages and disadvantages of each approach (refer to Chapter 2):</p> <ul style="list-style-type: none"> <li>• Approach 1 (consistent disclosures);</li> <li>• Approach 2 (capital ratio adjustments);</li> <li>• A combination of Approach 1 and Approach 2, applying to different aspects of material relative conservatism; or</li> <li>• Status quo – retain the existing approach?</li> </ul>
<b>Question 2</b>	<p>If APRA were to apply a combination of Approach 1 and Approach 2, which aspects of relative conservatism are best suited to be treated under Approach 2?</p>
<b>Question 3</b>	<p>Are there alternative approaches to those outlined in Chapter 2 that APRA should consider?</p>
<b>Question 4</b>	<p>What are the material considerations in regards to the disclosure of adjustments to capital ratio requirements under Approach 2? Should the level of disclosure of the adjustments be in aggregate only or also attributed to aspects of relative conservatism?</p>
<b>Question 5</b>	<p>Are there other implementation considerations that may arise with the approaches outlined in Chapter 2, such as costs in modifying systems and processes for capital calculations or integration into ADIs' strategic and capital planning cycles?</p>
<b>Question 6</b>	<p>Are there alternative measures to mitigate the operational complexity under Approach 2?</p>
<b>Question 7</b>	<p>Would increasing the size of capital buffers (either by increasing the CCB or by setting a non-zero baseline CCyB) relative to PCR appropriately balance capital strength with financial stability through the cycle?</p>
<b>Question 8</b>	<p>What may be some of the potential impacts if APRA increases the prescribed loss absorption trigger point above 5.125 per cent of RWA?</p>

### 4.3 Next steps

APRA is currently undertaking a quantitative impact study to calibrate the proposals detailed in the February 2018 Discussion Paper. APRA will initially consult on draft revised prudential standards without regard to the options outlined in this paper by the end of 2018. In early 2019, APRA will respond to the submissions in this Discussion Paper.

Depending on the outcome of this consultation, APRA expects to release for consultation draft revised prudential standards on credit and operational risks in 2019 that would incorporate any aspects set out in this Discussion Paper that APRA proposes to adopt.

APRA expects that final prudential standards would be released by mid-2020. In finalising the revised ADI capital framework, APRA will have regard to the Basel III implementation timetable. However, as indicated in the February 2018 Discussion Paper, it is likely that the revised prudential requirements would commence from 1 January 2021.

# Attachment A – Policy options and estimated comparative net benefit

The overriding objective of the proposed changes is to achieve more transparent and comparable capital ratios and improve the flexibility of the capital framework for ADIs. Within this context, APRA has considered four policy options as set out in Table 6 below. Also set out is APRA's preliminary analysis of the costs and benefits of each option.

Any information provided in response to the request for cost-benefit information in Chapter 4 will be used to quantify the change in regulatory burden using the Commonwealth Regulatory Burden Measure and inform APRA's determination of the net benefits of the options.

**Table 6** *Regulatory options*

<b>Option 1: Consistent disclosures</b>	APRA would specify adjustments to reported capital and RWA to enable more credible disclosure of ADI internationally comparable capital ratios without changing the definitions of capital and RWA.
<b>Option 2: Capital ratio adjustments</b>	APRA would adopt more internationally harmonised definitions of capital and RWA. The resultant increase in capital ratios would be offset by a transparent increase in individual ADI regulatory capital ratio requirements.
<b>Option 3: Maintain the current approach</b>	APRA would maintain its current approach to determining more conservative capital requirements than the internationally agreed minimum through tighter definitions of capital and determination of RWA.
<b>Option 4: Combination of options 1 - 3</b>	APRA could apply a combination of options 1 to 3 to different aspects of relative conservatism in APRA's capital framework. The approach applying to specific aspects of relative conservatism would be determined by APRA, taking into account feedback from consultation.

Under option 1, APRA would specify adjustments to reported capital and RWA but would not modify the current capital framework. This option would achieve the objective of improving transparency and comparability of capital ratios, which would improve ADIs' ability to participate in international capital markets, particularly during times of market dislocation, and give credibility to the adjusted capital ratios. However, as the ADI capital framework would not be modified for regulatory purposes, the comparability of capital ratios may be hampered by the existence of two APRA-endorsed capital ratios – a regulatory capital ratio and an additional disclosure-only capital ratio. This option would involve amendments to reporting and disclosure requirements and would therefore involve some implementation costs as ADIs would need to amend systems and processes.

Under option 2, APRA would amend the capital framework to use more harmonised definitions of capital and RWA. This approach would satisfy APRA's objectives as the conservatism APRA applies to capital and RWA would be more transparently understood, comparability of capital ratios would improve, and flexibility of the capital framework would

increase by varying the portions of minimum capital requirements and regulatory capital buffer requirements. As with option 1, this would involve some implementation costs as ADIs would need to amend systems and processes.

Under option 3, APRA would maintain its current approach to determining capital requirements for ADIs. Adopting this approach would not satisfy any of the objectives to improve the transparency and comparability of the ADI capital framework. Potential impediments to comparability of capital ratios arising from self-selection and self-reporting of internationally comparable ADI capital ratios would persist and transparency of the relative conservatism within APRA's capital framework would not be improved.

Under option 4, a combination of options 1 to 3 would be applied to different aspects of relative conservatism in APRA's capital framework for ADIs. There are some aspects of relative conservatism that are not material or are too complex to make an adjustment, so option 1 would be appropriate. For other aspects, option 2 or 3 would be appropriate. The use of the approaches may vary between standardised and IRB ADIs. Option 4 is likely to provide the greatest benefit as it could be tailored to minimise any unnecessary regulatory burden while achieving the objectives of improving transparency, comparability and flexibility of the ADI capital framework.



 **APRA**