RESPONSE TO SUBMISSIONS

Leverage ratio requirement for authorised deposit-taking institutions

27 November 2018

Contents

Executive Summary

Excessive leverage in the banking system was one the underlying causes of the global financial crisis, and demonstrated that banks were able to build up significant on- and off-balance sheet leverage, while continuing to report seemingly strong risk-based capital ratios. As part of the package of reforms developed in response to the global financial crisis, the Basel Committee on Banking Supervision (Basel Committee) introduced a non-risk-based measure of leverage to complement the risk-based capital framework. The adoption of a leverage ratio requirement for Australian authorised deposit-taking institutions (ADIs) was also separately recommended by the Financial System Inquiry.[1]

On 14 February 2018, the Australian Prudential Regulation Authority (APRA) proposed the introduction of a non-risk-based leverage ratio to act as a backstop to the risk-based capital framework for ADIs. The initial proposals broadly reflected the revised leverage ratio framework developed by the Basel Committee, as set out in *Basel III: Finalising post-crisis reforms*,[2] but included a number of proposals for simplification.

Respondents were broadly supportive of APRA's intention to introduce the leverage ratio, but some concerns were raised in relation to the calibration of the minimum leverage ratio requirement for ADIs authorised to use the internal ratings-based approach to credit risk (IRB ADIs), proposed deviations from the Basel III leverage ratio framework and the implementation timeframe.

Recognising these concerns, APRA has revised the calibration and calculation of the minimum leverage ratio requirement for IRB ADIs. These amendments are detailed in the body of this paper and reflected in the accompanying draft standard.

With regards to the proposed implementation date, APRA has decided to align the implementation of the leverage ratio with the broader revisions to the risk-based capital framework. APRA initially proposed that this would be from 1 January 2021, but following submissions on the revisions to the capital framework discussion paper,[3] is now proposing a 1 January 2022 implementation date. This also aligns with the Basel Committee's implementation date for these standards.

IRB ADIs will continue to be required to publically disclose their leverage ratios, as calculated under the current methodology, until the revised standard comes into effect. APRA expects that IRB ADIs will continue to maintain leverage ratios well above the proposed minimum requirement.

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[1] Financial System Inquiry, *Final Report* (November 2014) available at: http://fsi.gov.au/publications/final-report/chapter-1/leverage-ratio/.

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

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

Glossary

ADI	Authorised deposit-taking institution
APS 110	*Prudential Standard APS 110 Capital Adequacy*
APS 330	*Prudential Standard APS 330 Public Disclosure*
ARS 110.1	*Reporting Standard ARS 110.1 Leverage Ratio*
Basel III framework	A series of reforms to the Basel capital framework following the global financial crisis that commenced with the Basel Committee on Banking Supervision's *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010, revised June 2011) and includes the following reforms: • *Basel III: Finalising post-crisis reforms* (December 2017) which includes revisions to the frameworks for credit risk, credit valuation risk and operational risk, and introduces a floor on risk-weighted assets using the standardised approaches and a non-risk-based minimum leverage requirement; • *Minimum capital requirements for market risk* (January 2016); and • *Interest rate risk in the banking book* (April 2016).
Basel Committee	Basel Committee on Banking Supervision
CCF	Credit conversion factor
G-SIB	Global systemically important bank
IRB ADI	An ADI that has been granted approval from APRA to adopt the internal ratings-based approach for determining its capital adequacy requirements for credit risk.
SA-CCR	Revised counterparty credit risk requirements as set out in *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk*
Standardised ADI	An ADI that uses standardised approaches to determine its capital adequacy requirements.
SFT	Securities financing transaction

Chapter 1 - Introduction

1.1 Background

The build-up of excessive leverage in the banking system was one of the underlying causes of the global financial crisis, and demonstrated that banks were able to build up significant on- and off-balance sheet leverage, while continuing to report seemingly strong risk-based capital ratios. As part of the package of reforms developed in response to the global financial crisis, the Basel Committee on Banking Supervision (Basel Committee) introduced a non-risk-based measure of leverage to complement the risk-based capital framework.[4] The adoption of a leverage ratio requirement for Australian ADIs was also separately recommended by the Financial System Inquiry.[5]

In January 2014, the Basel Committee released *Basel III leverage ratio framework and disclosure requirements*, which set out its proposed methodology for calculating the leverage ratio.[6] Banks were required to publicly disclose their leverage ratios based on this methodology from 1 January 2015, with implementation as a minimum requirement from 1 January 2018. The Australian Prudential Regulation Authority (APRA) adopted the leverage ratio disclosure requirements in *Prudential Standard APS 110 Capital Adequacy* (APS 110) and *Prudential Standard APS 330 Public Disclosure* (APS 330). These standards required authorised deposit-taking institutions (ADIs) approved to use the internal ratings-based approach to credit risk (IRB ADIs) to disclose their leverage ratios under this methodology from 1 July 2015.

In December 2017, the Basel Committee published *Basel III: Finalising post-crisis reforms*, which incorporated revisions to the leverage ratio framework. These revisions included:

- a minimum leverage ratio requirement of 3 per cent;
- amendments to the calculation of the exposure measure; and
- a higher minimum and buffer requirement for global systemically important banks (G-SIBs).

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4 Basel Committee, *Basel III A global regulatory framework for more resilient banks and banking systems* (December 2010, revised June 2011), available at: https://www.bis.org/publ/bcbs189.htm.

5 Financial System Inquiry, *Final Report* (November 2014) available at: http://fsi.gov.au/publications/final-report/chapter-1/leverage-ratio/. This recommendation was subsequently endorsed by the Australian Government in *Improving Australia's financial system – Government response to the Financial System Inquiry* (October 2015), available at: https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/.

6 Basel Committee, *Basel III leverage ratio framework and disclosure requirements* (January 2014), available at: https://www.bis.org/publ/bcbs270.htm.

The Basel Committee's revised leverage ratio framework is intended to commence from 1 January 2022.

In February 2018, APRA released the discussion paper *Leverage ratio requirement for authorised deposit-taking institutions*, which outlined its initial proposals for implementing the leverage ratio as a minimum requirement, commencing 1 July 2019.[7] The proposals included a simpler accounting-based leverage ratio for standardised ADIs, as well as simplifications to the Basel III leverage ratio calculation for IRB ADIs. APRA also indicated that it would consider exempting small, less complex ADIs from the leverage ratio requirement as part of the proposed simplified framework.

1.2 Submissions received

APRA received seven submissions from ADIs and industry associations in response to the discussion paper. All respondents were supportive of APRA's intention to introduce a minimum leverage ratio requirement, but raised concerns in relation to:

- the calibration of the minimum leverage ratio requirement for IRB ADIs;
- proposed deviations from the Basel III leverage ratio framework; and
- the implementation timeframe.

APRA's response to these issues is set out in Chapter 2.

1.3 Draft prudential and reporting standards

Following consideration of the submissions received, APRA has revised the relevant draft prudential and reporting standards in order to implement the leverage ratio. Accompanying this paper are draft versions of:

- *Prudential Standard APS 110 Capital Adequacy* (APS 110); and
- *Reporting Standard ARS 110.1 Leverage Ratio* (ARS 110.1).

APRA welcomes submissions on these draft standards which are available at: https://www.apra.gov.au/leverage-ratio-requirements-adis

1.3.1 APS 110 Capital Adequacy

The draft APS 110 has been amended to reflect that a minimum leverage ratio requirement will be introduced for both IRB and standardised ADIs, with the exception of those standardised ADIs that meet the criteria for the simplified framework and are therefore

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7 APRA, *Leverage ratio requirement for authorised deposit-taking institutions* (Discussion Paper, February 2018), available at: https://www.apra.gov.au/implementing-basel-iii-capital-reforms-australia.

exempt from the leverage ratio requirement. The calculation of the leverage ratio exposure measure is detailed in Attachment D to APS 110.

In addition to the changes to give effect to the revised leverage ratio, APRA has also taken the opportunity to make other minor changes to APS 110. These relate primarily to consequential amendments arising from changes to other prudential standards, as well as other edits to improve the clarity of drafting and ensure consistency with the rest of the prudential framework. These amendments include:

- the addition of two footnotes resulting from APRA's introduction of direct issuance of mutual equity interests (MEIs) in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111). The first clarifies that all distributions on MEIs must be treated as dividends for the purpose of APS 110. The second clarifies that distributions on MEIs are subject to the specific limits set out in Attachment K to APS 111, in addition to the general profits test in APS 110;
- consequential changes as a result of the revised counterparty credit risk requirements, which are set out in *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk*;
- amendments to paragraph 36(a) to clarify that an ADI is not required to seek written approval from APRA prior to making a repayment of a Tier 2 Capital instrument upon its contractual maturity;
- amendments to Attachment B to clarify that the definition of earnings is for the purpose of that attachment only;
- indicative amendments to reflect that ADIs which meet the criteria for the simplified framework will not be subject to the leverage ratio; and
- other edits to remove components of APS 110 that were descriptive only.

These changes are also marked-up in the draft APS 110 for ease of identification.

1.3.2 ARS 110.1 Leverage Ratio

APRA is also introducing a new reporting standard – ARS 110.1 – to collect data on the leverage ratio, as ADIs do not currently report this information to APRA. For IRB ADIs, this includes proposals to collect the average, as well as highest and lowest reported ratios over the quarter. This seeks to reduce any incentives ADIs may have to engage in window-dressing behaviours as has been observed in other jurisdictions which have only adopted quarter-end reporting requirements.

ADIs which are not subject to the leverage ratio requirement under the simplified framework will still be required to report under ARS 110.1, in order to provide APRA with the data required to enable centralised public disclosure of the leverage ratio on behalf of these ADIs.

Chapter 2 - Response to submissions

2.1 Minimum leverage ratio requirement

APRA initially proposed implementing a minimum leverage ratio of 3 per cent for standardised ADIs and a higher requirement of 4 per cent for IRB ADIs.

Comments received

While respondents were supportive of the 3 per cent minimum for standardised ADIs, most did not support the 4 per cent minimum for IRB ADIs. Although acknowledging that a higher requirement for IRB ADIs was prudent, respondents asserted that a minimum of 3.5 per cent was more consistent with international peers. Respondents noted that a minimum of 3 per cent plus an additional 50 basis points, representing 50 per cent of the current domestic systemically important bank (D-SIB) buffer of 1 per cent, better aligns with the international methodology for calculating the leverage ratio buffer for G-SIBs.

One respondent noted that other prudential reforms, notably to credit conversion factors (CCFs) under the risk-based capital framework, will impact the calibration of the revised leverage ratio and that APRA should not prescribe a higher minimum leverage ratio requirement for IRB ADIs until these other reforms are finalised.

APRA's response

APRA remains of the view that a higher minimum leverage ratio requirement is appropriate for IRB ADIs. The proposal for a higher leverage ratio requirement reflects APRA's intention to strengthen this framework, with the application of a capital differential between standardised and IRB ADIs consistent with the approach to increased capital requirements in the risk-based framework. However, similarly to the risk-based capital framework, APRA's proposed application of higher CCFs will incorporate additional conservatism into the leverage ratio calculation, and result in reported ratios that are lower than if the Basel III minimum CCFs were adopted. Recognising this conservatism, APRA proposes to set the minimum requirement for IRB ADIs at 3.5 per cent.

APRA will also have the ability to set higher minimum leverage ratios for both standardised and IRB ADIs where the risk profile of a particular ADI necessitates a greater constraint on leverage.

2.2 Calculation of the exposure measure

2.2.1 Simplified exposure measure for standardised ADIs

APRA proposed introducing a simplified exposure measure for standardised ADIs. This would require standardised ADIs to calculate the exposure measure in accordance with Australian Accounting Standards, subject to some specified adjustments, rather than having to apply the more complex Basel III calculations for derivatives and securities financing transactions (SFTs).

Comments received

Respondents were supportive of APRA's proposal to adopt a simpler accounting-based leverage ratio exposure measure for standardised ADIs. While a couple of respondents noted that it would be preferable to exclude certain items from the exposure measure, such as assets subject to bilateral netting and pooling arrangements, they recognised that the proposed approach was materially accurate. Further, they noted that while excluding these items may improve the accuracy of the reported leverage ratio, it was not clear that this benefit was commensurate with the additional operational burden associated with introducing these exclusions.

APRA's response

The revised APS 110 has been drafted so that standardised ADIs must calculate their derivative and SFT exposures in accordance with Australian Accounting Standards, and are not required to adopt the more complex Basel III methodology.

As outlined in the accompanying media release ADIs which meet the criteria for inclusion within the simplified framework will not be subject to the leverage ratio requirement.[8] However, as indicated in section 1.3.2, APRA intends to disclose leverage ratios on behalf of these ADIs which will require reporting of a limited number of items to APRA.

2.2.2 Exposure measure for IRB ADIs

APRA proposed a number of simplifications to the Basel III exposure measure for IRB ADIs. These related primarily to the use of cash pooling, trade date accounting and, calculation of derivative and SFT exposures. APRA sought feedback from IRB ADIs on their preference for simplicity over international comparability.

Comments received

Respondents were generally not supportive of APRA's proposals to reduce complexity in the calculation of the leverage ratio exposure measure by deviating from the Basel III framework. Respondents noted a strong preference for international comparability over simplicity and requested APRA align with the Basel III leverage ratio framework.

APRA's response

On the basis of this feedback, the revised APS 110 has been drafted to largely follow the Basel III framework for the purpose of calculating the leverage ratio exposure measure. Some differences remain where APRA considers that a more conservative treatment is appropriate. These differences are detailed below.

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[8] APRA, 'APRA responds to submissions on leverage ratio, and extends timeline for broader capital framework reforms' (27 November 2018), available at: https://www.apra.gov.au/media-centre/media-releases/apra-responds-submissions-adi-leverage-ratio-and-extends-timeline.

Cash pooling

APRA initially proposed excluding cash pooling arrangements in their entirety from the calculation of the leverage ratio. Some respondents noted that they had arrangements in place that would meet the Basel III conditions, and not recognising these arrangements would lower reported leverage ratios.

APRA now proposes to allow IRB ADIs to recognise cash pooling arrangements in their calculation of the exposure measure only where the transfer of balances occurs at least on a daily basis. APRA does not intend to adopt the additional conditions set out in the Basel framework, that permit cash pooling arrangements to be recognised where balances are transferred at a lesser frequency.

Clearing services provided within multi-level client structures

Consistent with the approach implemented in the risk-based capital framework, APRA does not intend to adopt the Basel III concessions relating to providing clearing services as a higher level client within a multi-level client structure.

Written credit derivatives

APRA does not intend to recognise credit protection purchased on a subset of a pool of reference names as eligible to offset credit protection sold on the subset of a pool of reference names. Credit protection purchased must cover the entire pool in order to be eligible to offset written credit derivatives.

2.2.3 Modified standardised approach to counterparty credit risk

Consistent with the Basel III leverage ratio framework, APRA indicated that IRB ADIs would be required to use a modified version of the standardised approach to counterparty credit risk (SA-CCR) to calculate their derivative exposures for the purpose of the leverage ratio.

Comments received

A number of respondents raised concerns in relation to the use of a modified version of SA-CCR for the purpose of the leverage ratio. Two respondents requested that APRA adopt a transitional approach and allow IRB ADIs to use the unmodified SA-CCR exposure at default (EAD) in the leverage ratio until the Basel III leverage ratio implementation date of 1 January 2022. One respondent requested that APRA align the calculation of derivative exposures between the risk-based capital framework and the leverage ratio and allow IRB ADIs to use unmodified SA-CCR EAD for their leverage ratio calculations.

APRA's response

Given APRA's intention to align the implementation of the revised leverage ratio with the commencement of the broader revisions to the risk-based capital framework (refer to section 2.3), IRB ADIs will have additional time to develop and implement the modified version of SA-CCR for the purposes of the leverage ratio. APRA does not therefore intend to adopt a transitional approach in relation to this measure.

Regarding the request to align SA-CCR between the leverage ratio and risk-based capital framework, allowing the use of unmodified SA-CCR would allow IRB ADIs to recognise collateral in the calculation of their derivative exposures. This would be inconsistent with the principle that ADIs must not take account of physical or financial collateral to reduce the leverage ratio exposure measure. APRA therefore intends to continue to align with the Basel framework and require the use of the modified version of SA-CCR.

2.2.4 Balances held with the Reserve Bank of Australia

Consistent with the Basel III leverage ratio framework, cash and other balances held with the Reserve Bank of Australia (RBA) are required to be included in an ADI's exposure measure.

Comments received

Two respondents requested that APRA exclude cash balances held with the RBA from the leverage ratio exposure measure on the basis that including these balances as contributing to leverage could be counterintuitive in a volatile or stressed environment, and may impact the efficient operation of the payment system.

APRA's response

Although central bank reserves are required to be included in the exposure measure, the Basel III framework also includes a national discretion that allows a jurisdiction to temporarily exclude these exposures from the leverage ratio in exceptional macroeconomic circumstances. Where a jurisdiction exercises this discretion, it must also increase the minimum leverage ratio requirement by a commensurate amount to offset the impact of exempting the central bank reserves. If exercised, banks would also be required to disclose the impact of any temporary exemption alongside ongoing public disclosure of the leverage ratio without application of the exemption.

APRA acknowledges that the requirement to include central bank reserves in the leverage ratio may have the potential to impair the effective transmission of monetary policy during periods of macroeconomic stress, and so intends to allow for APRA to exercise this discretion in appropriate circumstances. To exclude central bank reserves in all circumstances would ignore that they do contribute to leverage, and would be inconsistent with the international framework.

2.2.5 Non-market-related off-balance sheet items

Consistent with the Basel III leverage ratio framework, APRA proposed to align the use of CCFs between the risk-based capital framework and the leverage ratio for the purpose of calculating exposures to non-market-related off-balance sheet items.

Comments received

A number of respondents noted that APRA's current proposals in relation to CCFs, as set out in the February 2018 discussion paper *Revisions to the capital framework for authorised deposit-taking institutions*, were more conservative than those in the Basel III framework. Requiring the use of APRA's more conservative CCFs would have a material impact on reported leverage ratios, result in an uneven playing field between Australian ADIs and international peers, and reduce international comparability.

APRA's response

The final calibration of CCFs will be determined as part of the continuing consultation on the revisions to the risk-based capital framework. However, APRA does not consider it appropriate to have two measures of CCFs – one for the risk-based capital framework and another for the leverage ratio. In this regard, APRA intends to align the application of CCFs under the leverage ratio with those in the revised *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*.

2.3 Implementation timeframe

Rather than adopt the Basel Committee's two-phase implementation of the leverage ratio, APRA proposed a single leverage ratio implementation date of 1 July 2019. Implementation at that time would be based on the revised leverage ratio exposure measure.

Comments received

Most respondents highlighted difficulties with meeting the proposed implementation date on the basis that there would be limited time between the release of the final standard and effective date, as well as interdependencies with implementing SA-CCR and the yet to be finalised changes to CCFs as part of the broader revisions to the risk-based capital framework. Respondents requested that APRA align its implementation of the leverage ratio with the changes to the risk-based capital framework, or align with the Basel III implementation date of 1 January 2022. Other respondents suggested implementing the leverage ratio as a minimum requirement under the current exposure measure from 1 July 2019, with calculation of the revised exposure measure to come into effect from 1 January 2022.

APRA's response

On the basis of the feedback received, APRA is open to aligning the implementation of the leverage ratio with the commencement of the broader revisions to the risk-based capital framework, i.e. effective 1 January 2022. Aligning on this basis will resolve the issue of a timing mismatch arising from the adoption of revised CCFs under the risk-based capital framework, and allow IRB ADIs sufficient time to develop systems for the use of the modified version of SA-CCR.

IRB ADIs will be required to continue publically disclosing their leverage ratios as calculated under the current exposure measure until the revised framework commences. In the interim, APRA expects that IRB ADIs will continue to report leverage ratios well above the proposed minimum of 3.5 per cent.

Chapter 3 - Consultation and next steps

3.1 Request for submissions and cost-benefit analysis information

APRA invites written submissions on the proposals set out in this discussion paper and the accompanying draft standards. Written submissions should be sent to ADIpolicy@apra.gov.au by 22 February 2019 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.

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 Commonwealth Regulatory Burden Measure 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.

3.2 Next steps and implementation

Following the receipt of submissions in response to this paper, APRA intends to release final standards for the leverage ratio with the final standards for the revisions to the risk-based capital framework. The revised APS 110 and ARS 110.1 are intended to commence at the same time as the revisions to the risk-based capital framework, i.e. 1 January 2022. Until that time, IRB ADIs must continue to calculate and disclose their leverage ratios under the existing framework.

APRA will also make consequential changes to APS 330 to reflect amendments to the exposure measure for IRB ADIs, and to introduce new leverage ratio disclosure requirements for standardised ADIs. As considerable changes to disclosure requirements are expected to result from the broader revisions to the risk-based capital framework, APRA intends to publically consult on the revised leverage ratio disclosure requirements as part of the broader package of amendments to APS 330.

APRA