Regulation Impact Statement

Basel III disclosure requirements: composition of capital and remuneration

(OBPR ID: 2013/15015)

Background

This Regulation Impact Statement (RIS) addresses the Australian Prudential Regulation Authority's (APRA's) proposal to introduce a revised prudential standard requiring locally incorporated authorised deposit-taking institutions (ADIs) to make specified public disclosures about the composition of their regulatory capital and their remuneration practices.

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can in all reasonable circumstances, meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system. APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. In the case of the banking industry, APRA is empowered under the *Banking Act 1959* (the Banking Act) to issue legally binding prudential standards that set out specific requirements with which ADIs must comply. APRA also publishes prudential practice guides (PPGs), which clarify APRA's expectations with regard to prudential matters.

Key aspects of the prudential framework applying to ADIs are based on the capital framework developed by the Basel Committee on Banking Supervision, of which APRA is a member. This framework consists of three 'Pillars':

- Pillar 1 sets out minimum amounts of regulatory capital that must be held by banking institutions as a buffer against credit, operational and market risks;

- Pillar 2 outlines two key processes - the supervisory review process, including APRA's discretion to increase capital for risks not captured under Pillar 1, and the ADI's own Internal Capital Adequacy Assessment Process (ICAAP); and
- Pillar 3 seeks to impose market discipline through public disclosure requirements for ADIs.

Under this framework, ADIs can calculate the amount of regulatory capital they must hold under Pillar 1 using either internal models or methods prescribed in the prudential standards. The former are known as Advanced ADIs and the latter, Standardised ADIs. Out of 132 locally incorporated ADIs as at March 2013, five have been approved by APRA as Advanced ADIs.

In 2008, APRA implemented Pillar 3 of the Basel framework through *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (existing APS 330), which applies to all locally incorporated ADIs. Under existing APS 330, ADIs must publically disclose specified information about their capital structure, capital adequacy, credit risk and securitisation. Advanced ADIs must disclose additional information about these matters, as well as information about market risk, operational risk, equities and interest rate risk in the banking book and must publish the full terms and conditions of their regulatory capital instruments. Subject to APRA's approval, there is an exemption for disclosures that might prejudice the position of an ADI by publicising information that is proprietary and/or confidential in nature.

APRA's current prudential framework does not require ADIs to make any disclosures about remuneration. Listed, large proprietary and some small proprietary ADIs, however, must include in their annual directors' report a 'Remuneration Report' in accordance with the *Corporations Act 2001* (Corporations Act), which requires qualitative disclosures about remuneration policies and procedures and qualitative and quantitative information about the remuneration of specified management personnel.

Problem

The global financial crisis that began in 2007 highlighted a number of deficiencies with the existing Basel capital framework. The Basel Committee developed a package of measures to address these deficiencies, known as 'Basel III'. Basel III measures to raise the quality and quantity of banking capital were implemented by APRA in prudential standards that came into effect on 1 January 2013. The RIS accompanying the making of these standards (OBPR ID: 2012/13813) provides further information

about deficiencies in the capital framework identified during the crisis, the impact of the crisis on Australia and the rationale for APRA's implementation of Basel III[1].

One deficiency identified during the crisis was that the current capital disclosure requirements were not sufficient to assuage market concerns about the capital adequacy of troubled banking institutions. These concerns, although not the cause of the crisis, did play a role in exacerbating market uncertainty and prolonging instability in global financial markets. The intensity of the instability in markets overseas was not replicated in Australia. However, the global experience does demonstrate what can happen where a loss of confidence in the banking sector occurs. It is therefore important that sufficient measures are in place to guard against factors that can contribute to market uncertainty – whatever the root cause of that uncertainty – including a lack of timely and reliable information.

Attempts to discern the level and quality of regulatory capital during the crisis also demonstrated that the approach taken by individual institutions varies widely within and across jurisdictions. This inhibits the ability of investors, shareholders, customers, ratings agencies and the media to make appropriate comparisons, the effects of which can contribute to a loss of confidence in particular institutions. These impacts can occur during normal times, independently of any systemic financial crisis.

As a result of these concerns, as outlined in the RIS accompanying APRA's recent implementation of its capital reforms, Basel III included revised Pillar 3 measures relating to the disclosure of the composition of regulatory capital in banking institutions of member jurisdictions. The Basel Committee released the rules text governing these requirements in June 2012[2].

Also during the recent global turmoil, failures of a number of overseas financial institutions coincided with remuneration practices that encouraged unsound risk-seeking behaviour, giving rise to concerns that remuneration practices in the financial sector encouraged behaviour contrary to financial stability and the soundness of financial institutions. These concerns were sufficiently significant and widespread to prompt global reform through the Financial Stability Board's (FSB) *Principles for Sound Compensation Practices*[3], which sought to ensure that remuneration practices are properly aligned with an institution's risk management framework. APRA acknowledged that the level of risk-taking seen in other jurisdictions was not broadly observed in ADIs in Australia, but the FSB's *Principles* were nonetheless equally

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[1] http://www.apra.gov.au/Policy/Documents/September-2012-Basel-III-capital-regulation-impact-statement.pdf

[2] *Composition of capital disclosure requirements,* June 2012: http://www.bis.org/publ/bcbs221.htm.

[3] www.financialstabilityboard.org/publications/r_0904b.pdf

relevant to Australia. Accordingly in 2009, APRA incorporated the FSB principles into *Prudential Standard APS 510 Governance* (now *Prudential Standard CPS 510 Governance* (CPS 510)). Further details about the rationale for implementing remuneration requirements are included in the RIS accompanying the making of APS 510 in 2009 (OBPR ID: 2009/10819)[4].

A subsequent FSB review of compensation practices across member jurisdictions, including Australia, noted differences in disclosure practices that could hamper the comparability of disclosed information and, therefore, the overall effectiveness of disclosure as a whole[5]. Following this review, in July 2011 the Basel Committee released measures to include within Pillar 3 disclosure requirements for remuneration to apply globally to banking institutions[6], based on the FSB *Principles.*

In Australia, there are already statutory requirements on the disclosure and governance of executive compensation for listed ADIs. Under section 300A of the Corporations Act, listed, public and other companies are required to publish annually in a section of the directors' report for the financial year:

- a discussion of the policy for determining remuneration;
- a discussion of the relationship between the policy and company performance;
- if an element of remuneration is dependent on a performance condition, a summary of the performance condition and explanation of why it was chosen; and
- remuneration details for key management personnel, including the five group executives and five company executives who earn the highest remuneration.

The Pillar 3 disclosure requirements overlap with, but are broader in scope than, the Corporations Act requirements for an ADI's' remuneration report.

Objectives

APRA is proposing to incorporate the Basel Committee's Pillar 3 measures relating to the composition of capital and remuneration into APRA's prudential framework. These measures include requiring an ADI to disclose:

- the composition of its regulatory capital in a standard form;

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[4] http://www.apra.gov.au/lifs/PrudentialFramework/Documents/CLEARED-RIS-OBPR-attach-to-ES-26-Nov.pdf

[5] *Thematic Review on Compensation – 2010 report* (30 March 2010): http://www.financialstabilityboard.org/publications/r_100330a.htm

[6] *Pillar 3 Disclosure Requirements for Remuneration* (1 July 2011): http://www.bis.org/publ/bcbs197.htm

- a reconciliation between the composition of its regulatory capital and its published financial statements;
- the full terms and conditions of its regulatory capital instruments and the main features of these instruments in a standard form;
- quantitative and qualitative information about its capital adequacy; and
- quantitative and qualitative information on its approach to remuneration, including aggregate information on its remuneration of senior managers and material risk-takers.

Other measures include a requirement for an ADI to have a disclosure policy approved by the Board of directors and a separate 'Regulatory Disclosures' section on its website.

The capital disclosure requirements are intended to achieve two objectives. The first is to provide market participants with detailed information about an ADI's regulatory capital and to explain any differences between regulatory capital and financial statements produced under accounting standards in accordance with the Corporations Act.

The second objective is to provide a standardised approach to disclosure to facilitate comparisons between institutions and between jurisdictions. This is to be achieved by requiring strict adherence to standard templates through which disclosures are made. This is intended to empower all stakeholders to review summarised information about the composition of capital and to make 'like-for-like' comparisons between institutions, and thus make informed decisions about banking with, or investing in, particular ADIs. Overall, it is intended that improved disclosure will bolster confidence in the banking system.

The objective of the remuneration disclosure requirements is to enhance effective market discipline by allowing stakeholders to assess the quality of the compensation practices and the extent to which those practices support an institution's strategy and encourage sound risk management. To this end, the quantitative disclosure measures focus on senior managers and 'material risk-takers', with this latter category being broader in scope than the key management personnel included in remuneration reports prepared under the Corporations Act. APRA's remuneration disclosure requirements are designed to be sufficiently granular and detailed to allow meaningful assessments of an ADI's compensation practices, while not requiring disclosure of sensitive or confidential information. The remuneration disclosure requirements also require a standardised form and location of disclosure to further facilitate comparison and, again, to contribute to confidence in individual institutions and the banking system overall.

Australia is a member of the Basel Committee, FSB and Group of 20 (G20) and the Government has committed to implementing these measures. It also important for

APRA's reputation that it implements reforms it actively helped develop and to continue to align its prudential regime with international best practice.

Options

APRA has identified four options to address the identified deficiencies in Australia's disclosure requirements for ADIs:

- maintain APRA's existing prudential framework (Option 1 - status quo);
- implement the Basel III composition of capital and remuneration disclosure requirements on a voluntary basis, such as through a new Prudential Practice Guide (PPG), which would not create enforceable obligations for ADIs (Option 2 - voluntary adoption);
- implement the Basel III composition of capital and remuneration disclosure requirements through revisions to APS 330 that would impose enforceable disclosure obligations on ADIs (Option 3 - mandatory implementation from 30 June 2013); or
- defer implementing the Basel III composition of capital and remuneration disclosure requirements through revisions to APS 330 that would impose enforceable disclosure obligations on ADIs (Option 4 - mandatory implementation with a deferred implementation date).

Option 1 — status quo

Under this option, existing APS 330 would remain unchanged. This would mean that ADIs would continue to make some Pillar 3 disclosures about capital. Only Advanced ADIs would be required to make available summary information on the terms and conditions of regulatory capital instruments; they would also continue to make disclosures about their approach to various risks. Standardised ADIs would continue to make limited disclosures about capital structure, capital adequacy, credit risk and securitisation.

The primary benefit of this option is that it would impose no new compliance costs on ADIs. However, it would mean that the identified lack of transparency in relation to regulatory capital would continue, to the potential detriment of stakeholders. It is possible for some market participants such as institutional investors and credit rating agencies to overcome this lack of transparency by directly requesting more detailed information from particular ADIs. However, this is not likely to be possible for customers or smaller investors. Further, there would be no requirement for ADIs to provide the information in a comparable format or to the same level of detail that would be the case under the proposed measures.

As stated previously, retaining the status quo has the potential to contribute to diminished confidence in individual institutions or the banking system, which could have adverse impacts on funding, share prices and/or liquidity.

Failure to implement the Basel III composition of capital and remuneration disclosure requirements would also negatively affect Australia's reputation and conflict with Australia's G20 commitment to implement the Basel III reforms no later than the internationally agreed timeframe.

Option 2 — voluntary adoption

Under this option, the Basel III composition of capital and remuneration disclosure requirements would be introduced in Australia on a voluntary basis, e.g. through a new PPG. This would provide guidance but not legally enforceable obligations for Australian ADIs to report the information required under Basel III. The key benefit would be flexibility in determining the type and level of disclosures and when they would be made. Additional compliance costs would depend on these choices.

Accounting standards, listing requirements, disclosure requirements and internal management information systems within ADIs are routinely revised and amended. As such ADIs should already have appropriate systems in place to assess, respond to and implement changes to accommodate new prudential disclosure requirements.

Some Advanced ADIs already disclose some capital ratios on a voluntary basis, comparing their capital adequacy based on APRA's implementation of the Basel framework with their interpretation of the requirements of another jurisdiction or jurisdictions (such as the UK or Canada). They do not, however, make these disclosures using identical base data, in a consistent format or in a standard location. They are intended for analysts and institutional investors and not designed to facilitate analysis or comparisons by other market participants such as customers or small investors. They also do not have the granularity of the specific components of regulatory capital required under Basel III. APRA is concerned that this lack of consistency and ability to choose which disclosures to make, how detailed to make them and where and when they should be made will not achieve the proposal's objectives of providing detailed information in a standardised format.

ADIs already make public disclosures to meet APRA's requirements under APS 330 (including disclosure of capital ratios) and, for the majority, to meet Corporations Act requirements such as in relation to remuneration. To meet these regulatory requirements, ADIs must have in place systems and procedures to collate, confirm and release the requisite information. Thus, ADIs are already able to interrogate databases and other sources to obtain information about capital and remuneration and have appropriate communication and governance processes to facilitate public release, including ensuring that disclosures are consistent with information already provided to the ADI's auditor and APRA.

Initially, ADIs will need to incorporate new information requests into their systems and procedures, including accommodating new publication formats. For example, when an ADI issues a new capital instrument, all the terms and conditions of that instrument are set out in a detailed prospectus, which need not be in a particular

format or located in the same location as such information available from another ADI. Under APS 330, however, this data is to be disclosed in one place for all of the ADI's capital instruments, and in a standard format. These costs will not be ongoing.

Those ADIs with a number of entities in their group that are outside the scope of regulatory consolidation but not financial consolidation, and vice-versa, will need to expend some time and effort in compiling and disclosing the list of these entities and information about their assets, liabilities and principal activities. These costs will not be replicated for subsequent disclosures, except to the extent necessary to update the list of these entities.

With the exception of the regulatory capital reconciliation, information to be disclosed under APRA's proposed measures would be obtained and published using these existing procedures and systems and procedures. The reconciliation document may also require input from internal and/or external accounting personnel. Under this option, an ADI would also need to provide policy staff to assess and draft a recommendation for the nature, extent and format of disclosures to be made voluntarily and for senior management and the Board to consider and make an appropriate decision. Once the ambit of voluntary disclosure is determined and incorporated into existing procedures and systems, additional costs (if any) would be because of the increase in the number of information requests, the frequency and timing of disclosures, and the need to publish these in the agreed format.

APRA notes that many ADIs did not take up its invitation for voluntary disclosure of remuneration, issued in a letter to industry dated 7 October 2011.[7]

Option 3 — mandatory implementation from 30 June 2013

Under this option, APRA would implement the Basel III composition of capital and remuneration disclosure requirements through a new version of APS 330 that would come into effect in line with the Basel Committee's 30 June 2013 timetable.

APRA accepts that ADIs would face some additional compliance costs under this option and it specifically sought assessments of the compliance impact of the proposed changes as part of its consultation on the proposal. No submissions were received that quantified likely compliance costs or otherwise outlined their scale and scope. In APRA's view, the nature of these costs are as outlined under Option 2, namely:

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[7] http://www.apra.gov.au/adi/Publications/Documents/Letter-to-industry-Remuneration-Disclosures-071011.pdf

- the ADI must have a disclosure policy that addresses the new measures, requiring policy/compliance staff to prepare Board papers for senior management and Board approval;
- initially, existing systems and procedures will need to be updated to incorporate additional information requests and the new disclosure templates;
- initially, ADIs with a large number of entities included in the group will need to identify and separately list those that are outside the scope of regulatory consolidation but included in financial consolidation, and vice-versa, but this list is unlikely to change significantly for subsequent disclosures;
- ADIs may need to engage accounting assistance to prepare and/or review the regulatory capital reconciliation; and
- higher costs may be incurred on an ongoing basis as a result of the increases in the number of information requests, the timing and frequency and methods of disclosure.

It is APRA's view that the costs of complying with the proposed measures will not be material. The disclosures are linked to prudential requirements such as those related to capital and remuneration practices that ADIs must already meet. Any additional compliance costs will arise from compilation of existing data, internal approval and publication costs. In some cases, after the initial disclosure (e.g. the terms and conditions of regulatory capital instruments), subsequent compliance costs will be lower as the disclosure only needs to be updated as capital events occur.

The requirement that is most likely to involve some additional costs is the regulatory capital reconciliation, where the information is not necessarily to hand immediately. However, APRA expects that the reconciliation should not impose an unreasonable cost burden. APRA does not envisage that increased compliance costs from these reforms will be passed onto third parties (including banking customers) in any explicit manner due to their lack of materiality.

It is APRA's view that the proposal will provide public benefit that is, however, unable to be quantified. There should be an immediate benefit in improving the level of publically available information about individual ADIs' capital and remuneration, to facilitate more thorough assessment of individual institutions and comparisons between institutions in Australia and in other jurisdictions. The remuneration disclosure measures in particular are intended to provide market participants with information that may ultimately discourage remuneration practices that can encourage high-risk activities in the banking system. There is also benefit in having a well-informed market that provides discipline on deficiencies in remuneration practices in advance of any future crisis in a particular institution or institutions.

APRA has also considered whether the quantitative remuneration disclosures in particular might lead to a breach of an individual's privacy. This data is to be provided on an aggregated basis but APRA acknowledges that there may be some circumstances in which an individual's remuneration arrangements could be

identified. Existing APS 330 includes a provision under which, with APRA's approval, an ADI may be excused from disclosing confidential or proprietary information. The revised APS 330 extends this provision to cover personal information under the *Privacy Act 1988*, which APRA believes addresses this potentially adverse impact.

Option 4 – mandatory implementation with a deferred commencement date

Under this option, APRA would implement the Basel III composition of capital and remuneration disclosure requirements through a new version of APS 330 but would defer the implementation date. Compliance costs would be as stated under Options 2 and 3.

This option would address concerns expressed by some ADIs, with a balance sheet reporting date of 30 June 2013, about the short timeframe between the April/May consultation period and finalisation of a revised APS 330 to come into effect for reporting dates on or after 30 June 2013.

Proposals for new capital and remuneration disclosures have been in the public domain for some years. The Basel Committee released its draft Basel III capital package in December 2009 and its remuneration disclosure proposals in December 2010. APRA advised industry several times during this period of its intention to implement the Basel measures in full. APRA's proposals do not materially depart from the final rules texts released by the Basel Committee in July 2011 and June 2012. Delaying the implementation of the capital and remuneration disclosures would not reduce the compliance costs but would simply defer them.

APRA does, however, accept that ADIs with 30 June reporting dates have a short timeframe in which to be satisfied that their disclosures comply with the final version of APS 330. APRA has accordingly agreed that these institutions may meet its disclosure requirements for the period ending 30 June 2013 on a 'best endeavours' basis.

Consultation

Before releasing its final measures, the Basel Committee sought public comments on its consultative documents, *Pillar 3 disclosure requirements for remuneration*,[8] and

[8] http://www.bis.org/publ/bcbs191.htm.

Definition of capital disclosure requirements,[9] released in December 2010 and December 2011, respectively.

In letters to industry in 2009 and 2010, APRA advised its intention to implement in full the Basel III measures, including disclosure requirements, in full. This point was also made in APRA's discussion paper, *Implementing Basel III capital reforms in Australia* (September 2011). In an October 2011 letter, APRA advised industry that it would incorporate the Basel Committee's remuneration disclosure measures into its prudential framework.

In April 2013, APRA released a consultation package outlining its detailed proposals to implement the Basel III capital and remuneration disclosure requirements in Australia. The period for submissions closed on 16 May 2013.

The consultation package consisted of a discussion paper, Basel III disclosure requirements: composition of capital and remuneration and a draft prudential standard, *Prudential Standard APS 330 Public Disclosure* (draft APS 330).

Submissions received

APRA received eight submissions and also met with industry representatives during the consultation period. The submissions broadly supported adopting the Basel III capital and remuneration disclosures. Of primary concern was the implementation date of 30 June 2013 and whether it is appropriate for ADIs that are not internationally active and/or that are unlisted or member-owned should be subject to the proposed requirements. Other queries sought clarifications, such as whether the disclosures must be audited and how to address potential privacy concerns relating to remuneration (discussed above). These queries will be addressed in a separate paper responding to submissions.

APRA acknowledges the short timeframe between the consultation package and the proposed implementation date but notes that industry has been on notice for some time of the new Pillar 3 requirements. ADIs that will be required to make public disclosures for the period ending 30 June 2013 may do so on a 'best endeavours' basis. Disclosures in subsequent reporting periods must fully comply with the new APS 330.

APRA considered whether ADIs that are not internationally active or that are unlisted or mutually owned should be exempted from the disclosure requirements. Although one objective of the Basel Committee is to facilitate cross-jurisdictional comparisons

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[9] http://www.bis.org/publ/bcbs212.htm.

between banking institutions, this is not APRA's only objective. Market participants will equally benefit from transparent disclosures by Australian ADIs, whether or not those ADIs are internationally active or are owned by members rather than shareholders. Furthermore, ADIs are expected to comply with the requirements only to the extent it is applicable to them. Consequently, APRA does not intend to allow any exemption from the capital and remuneration disclosure requirements.

Conclusion and recommended option

The global financial crisis prompted a series of internationally agreed reforms to strengthen the resilience of banking systems. In Australia, APRA has implemented (or is in the process of implementing) these reforms in accordance with its mandate as prudential regulator of the Australian banking system. In particular, it has implemented the Basel III reforms to strengthen the capital adequacy framework as well as reforms to remuneration practices to discourage imprudent risk-taking behaviour.

This proposal is intended to implement the final component of these reforms by requiring ADIs to incorporate revised disclosure requirements into their Pillar 3 disclosures. The purpose is to enhance market discipline by enabling market participants to assess the capital position and remuneration practices of individual institutions. The disclosure requirements are intended to address concerns about deficiencies in information that contributed to market uncertainty, volatility and, in extreme cases, dislocation in banking systems overseas. Although these systemic impacts were significantly less intense in Australia, the crisis provides a salutary lesson to all banking institutions. APRA's proposal to enhance public disclosure will serve as a precaution against the potential for inadequate information to exacerbate market disruption during a period of turmoil.

The new requirements are more detailed than under the existing APS 330 and are to be met using standard formats, frequencies, timeframes and locations in this way facilitating comparisons between institutions in Australia and across jurisdictions. This standardisation is intended to benefit all market participants, including large and small shareholders, investors and customers as well as rating agencies, analysts and media. Voluntary adoption will not achieve this objective as it is likely that the standardisation of disclosure provided under the proposal would be lost and, inevitably, some ADIs will not adopt. Most of the information to be disclosed already exists or can be readily compiled and will not require significant additional compliance costs. In APRA's view, improved comparability, standardisation, market discipline and the potential to prevent future market uncertainty outweighs the relatively minor additional compliance costs.

Finally, the implementation date is globally agreed and was announced some time ago by the Basel Committee, and APRA has consistently advised industry of its intention to implement the disclosure measures in full from that date. Accordingly, APRA does

not propose to change the implementation date. However, it will accept entities reporting the new Pillar 3 disclosures on capital and remuneration on a 'best endeavours' basis for the June 2013 reporting period. APRA is of the view that this strikes a pragmatic balance between accommodating some ADIs' concerns about the implementation date and meeting Australia's international commitments. APRA therefore proposes to adopt option 3.

Implementation and review

The Basel III disclosure requirements are to be implemented in a revised version of APS 330 that is to commence on 30 June 2013 and apply to locally incorporated ADIs in Australia.

APRA's prudential requirements will be reviewed as necessary to ensure they continue to reflect good practice and remain relevant and effective.