Financial Sector (Collection of Data) (reporting standard) determinations Nos. 1-43 of 2006

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (**APRA**)
Issued by the authority of APRA

Financial Sector (Collection of Data) Act 2001 (**the Act**), paragraph 13(1)(a)

Acts Interpretation Act 1901, subsection 33(3)

Under paragraph 13(1)(a) of the Act, APRA may, by writing, determine reporting standards with which financial sector entities must comply. Such standards relate to reporting financial or accounting data and other information regarding the business or activities of the entities. Subsection 33(3) of the *Acts Interpretation Act 1901* provides that where an Act confers a power to issue an instrument the power shall, unless the contrary intention appears, be construed as including a power exercisable in the like manner and subject to the like conditions (if any) to amend or vary any such instrument.

Financial Sector (Collection of Data) (reporting standard) determinations Nos. 1 - 42 of 2006 (**the instruments**) respectively revoke and replace the reporting standards (which were originally determined on 15 December 2004 to have effect from 1 January 2005) outlined below in respect of Authorised Deposit Taking Institutions (**ADIs**) regulated by APRA:

ARS 110.0 (2005)	Capital Adequacy
ARS 112.1 (2005)	On Balance Sheet Risk Weighting Schedule
ARS 112.2 (2005)	Off Balance Sheet Business Return
ARS 113.0 (2005)	Market Risk
ARS 113.1 (2005)	Repricing Analysis
ARS 210.0 (2005)	Statement of High Quality Liquid Assets Calculation (Licensed ADI)
ARS 220.0 (2005)	Impaired Assets
ARS 220.3 (2005)	Prescribed Provisioning
ARS 220.5 (2005)	Movements in Provisions for Impairment
ARS 221.0 (2005)	Large Exposures
ARS 222.0 (2005)	Exposures to Related Entities
ARS 230.0 (2005)	Commercial Property
ARS 231.1a (2005)	International Exposures: Locational (Assets) Part 1
ARS 231.1b (2005)	International Exposures: Locational (Liabilities) Part 1
ARS 231.2 (2005)	International Exposures: Locational Part 2
ARS 231.3a (2005)	International Exposures: Consolidated (Domestic Entity)
ARS 231.3b (2005)	International Exposures: Consolidated (Foreign Entity)
ARS 320.0 (2005)	Statement of Financial Position (Domestic Books)
ARS 320.1 (2005)	Debt Securities Held
ARS 320.2 (2005)	Equity Securities Held

ARS 320.3 (2005)	Debt Securities on Issues
ARS 320.4 (2005)	Accepted and Endorsed Bills
ARS 320.5 (2005)	Securities Subject to Repurchase & Resale & Stock Lending & Borrowing
ARS 320.7 (2005)	Deposits and Loans Classified by State and Territory
ARS 320.9 (2005)	Intra-Group Receivables and Payables
ARS 321.0 (2005)	Statement of Financial Position (Offshore Operations)
ARS 322.0 (2005)	Statement of Financial Position (Consolidated)
ARS 323.0 (2005)	Statement of Financial Position (Licensed ADI)
ARS 325.0 (2005)	International Operations
ARS 326.0 (2005)	Offshore Banking Units
ARS 330.0 (2005)	Statement of Financial Performance
ARS 330.1 (2005)	Interest Income and Interest Expense
ARS 330.2 (2005)	Other Operating Income
ARS 330.3 (2005)	Other Operating Expenses
ARS 331.0 (2005)	Selected Revenue and Expenses
ARS 332.0 (2005)	Statement of Economic Activity
ARS 391.0 (2005)	Commercial Finance
ARS 392.0 (2005)	Housing Finance
ARS 393.0 (2005)	Lease Finance
ARS 394.0 (2006)	Personal Finance
ARS 395.0 (2005)	Business Finance
ARS 396.0 (2005)	Points of Presence

Under subsection 15(1) of the Act, APRA has determined that the instruments will come into force on 1 July 2006.

Financial Sector (Collection of Data) (reporting standard) determination No.43 of 2006 revokes the Reporting Standard CRS 400.0 Specialist Credit Card Institutions. Under section 15(1) of the Act, APRA has determined that CRS 400.0 Specialist Credit Card Institutions will cease to apply on the date of registration of Financial Sector (Collection of Data) (reporting standard) determination No.43 of 2006 on the Federal Register of Legislative Instruments.

1. Background

This Explanatory Statement explains the changes being made by APRA to the reporting framework for ADIs in response to Australian equivalents to international financial reporting standards (**AIFRS**). ADIs have adopted AIFRS for reporting periods beginning on or after 1 January 2005.

Each reporting standard comprises: (1) the body of the reporting standard itself (which contains details about inter alia when returns under the standards must be lodged with APRA); (2) one or more reporting forms which must be completed by ADIs covered by the reporting standard; and (3) a set of detailed technical instructions regarding completion of the form.

The changes to Australian accounting standards that flow from the adoption of AIFRS, if left unadjusted, would automatically flow through to APRA's reporting framework. APRA's objective in its approach to AIFRS is to align its reporting

standards with Australian accounting standards and principles to the extent practicable, as the latter provide a widely accepted basis for the recognition and measurement of assets, liabilities, equity, revenue and expenses. As an interim step Determination No. 8 of 2004 preserved references to accounting standards immediately before 1 January 2005.

2. Purpose of the instrument

The purpose of each instrument is to revoke those reporting standards, applying to ADIs, whose operation is affected by AIFRS and to replace them with corresponding standards which incorporate appropriate adjustments (new standards). APRA considered that it would be clearer and more effective to consolidate the necessary changes within new standards. For that reason, APRA decided to revoke and replace affected reporting standards rather than to amend them. APRA has also taken this opportunity to update the formatting of instructions attaching to all ADI reporting standards. Therefore APRA has revoked all ADI reporting standards and redetermined them.

Financial Sector (Collection of Data) (reporting standard) determination No. 43 of 2006 revokes the *Reporting Standard CRS 400.0 Specialist Credit Card Institutions* (CRS 400.0). CRS 400.0 which applies to specialist credit card institutions (SCCIs) was determined in 2003 to require SCCIs to report under certain reporting standards. In 2005 APRA updated the ADI reporting standards to include the SCCI reporting requirements thereby making CRS 400.0 redundant. The SCCI reporting requirements are also included in the new reporting standards.

3. Operation of the instruments

The instruments determine the new standards.

The new standards now ensure that any references to accounting standards immediately before 1 January 2005 are **not** preserved in the reporting standards and instructions. References to accounting standards and Australian accounting standards Board (**AASB**) standards have been updated to AIFRS accounting standards. Accordingly, AIFRS must be applied by ADIs, where instructed, when completing forms under the reporting standards listed above.

The new standards also delete one identical note at the end of each set of instructions. That note provided that certain references to accounting standards in the instructions were taken to be references to those accounting standards as they apply in respect of reporting periods (within the meaning of the accounting standards) commencing immediately before 1 January 2005. The deletion ensures that references in the instructions to accounting standards are taken to be references to those accounting standards from 1 January 2005 as they are under AIFRS.

The new standards also insert an identical note in each set of instructions below:

“Securitisation Deconsolidation Principle

Except where stated otherwise on this form, reporting entities must treat any securitisation program special purpose vehicles (SPVs) in which the ADI (or a member of its consolidated group) participates in accordance with APRA's clean sale and separation requirements as non-consolidated independent third parties. As a result, for reporting purposes all assets, liabilities, revenues and expenses of these SPVs must be excluded from the ADI's reported amounts. Where relevant, report on this form any exposure to or other transaction between the ADI and any such SPV as if such transaction was conducted with an independent third party, regardless of whether the SPV or its assets is consolidated for accounting purposes.

APRA's clean sale and separation requirements are set out in *APS 120 Funds Management and Securitisation* and related *Guidance Notes AGN 120.3 Purchase and Supply of Assets (including Securities Issued by SPVs)* and *AGN 120.1 Disclosure and Separation*. Whenever the clean sale and separation requirements are not met, all the assets, liabilities, revenues and expenses of the SPV are to be consolidated with the ADI's reported amounts."

The forms and instructions have been revised taking account of the impact of AIFRS. The core changes are as follows:

- **Terminology changes** – Use of AIFRS and prudential terminology (e.g. Deferred Tax liability replaced with Provision for Deferred Tax, General Provisions replaced with General Reserve for Credit Losses);
- **New items** – New AIFRS items (e.g. Derivative financial instruments, Defined Benefit assets and liabilities, Loan loss provisioning);
- **Prudential Policy changes –** these changes reflect AIFRS revised prudential treatments for Tier 1 capital, securitised assets, fair value measurement, provisions, cashflow hedges, property and employer-sponsored defined benefit funds, treatment of impaired facilities, available for sale reserves.

In addition, there have also been changes to update the formatting of the instruction guides, including drafting changes to ensure consistency between different reporting standards. These changes do not affect the content of the reporting standards or instruction guides.

4. Consultation

Industry wide consultation has been held over a 12-month period with a number of interested parties including:

- ADIs; and
- Industry bodies eg Australian Bankers Association.

APRA has consulted the Reserve Bank of Australia (RBA) and Australian Bureau of Statistics (ABS) when developing the AIFRS regulatory reports. Feedback received from these bodies has been incorporated within the final set of reports.

5. Regulation Impact Statement

A regulation impact statement is attached.

Regulation Impact Statement

Introduction

This Regulation Impact Statement covers proposed changes to the prudential and reporting framework for authorised deposit-taking institutions (**ADIs**) in response to the introduction of Australian equivalents to International Financial Reporting Standards (**AIFRS**). ADIs have adopted AIFRS for reporting periods beginning on or after 1 January 2005.

The Australian Prudential Regulatory Authority (**APRA**) is primarily responsible for ensuring the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors and insurance policyholders (**beneficiaries**). The introduction of AIFRS has implications for APRA's mandate and may require amendments to prudential standards made under the *Banking Act 1959* and reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

Background

Australian reporting entities are adopting AIFRS for reporting periods beginning on or after 1 January 2005. The adoption of AIFRS changed Australian generally accepted accounting principles (**AGAAP**) in place prior to that date in relation to the recognition and measurement of assets, liabilities, equity, revenue and expenses. As a result of the adoption of AIFRS, ADIs now use these new accounting standards as the basis for their financial reports prepared in accordance with the *Corporations Act 2001* (**general purpose financial reports**).

APRA's prudential requirements are aimed at protecting the interests of beneficiaries, particularly in adverse circumstances, while general purpose financial reports focus on evaluating the interests of the economic owners of an institution on a going-concern basis. Because of these differing objectives, prudential reporting requirements sometimes differ from accounting requirements, although APRA seeks to align its prudential and reporting standards with Australian accounting standards to the extent practicable. Prudential reporting also pays regard to standards issued by the Basel Committee on Banking Supervision (**Basel Committee**), which provides a forum for regular cooperation on banking supervisory matters. Over recent years, the Committee has developed increasingly into a *de facto* standard-setting body on all aspects of banking supervision, including the Basel II capital adequacy framework.

Any changes to the prudential and reporting framework for ADIs consequent on AIFRS would affect 231 institutions (as at 31 December 2005), with 40 per cent of

these institutions each holding assets under $100 million and only five per cent each with assets greater than $20 billion. As at February 2006, beneficiaries held deposits of $552 billion with these institutions.

Problem identification

AIFRS has changed the basis for recognition and measurement of assets, liabilities, equity, revenue and expenses. Further details about the differences between AGAAP and AIFRS are provided in Appendix 1.

AIFRS will provide the accounting basis for APRA's prudential and reporting framework. At the same time, however, the adoption of AIFRS could have significant implications for an ADI's regulatory capital base if allowed to flow through fully to the prudential framework. In particular, AIFRS introduces:

- a stricter definition of equity that, on initial adoption, could result in certain financial instruments currently classified as equity being reclassified as liabilities.

  If left unadjusted, the Tier 1 capital position across the ADI industry would be reduced by approximately $15 billion, significantly affecting compliance with APRA's regulatory capital requirements; and

- more stringent requirements on removal from the balance sheet of financial assets sold to securitisation vehicles.

  This is likely to result in financial assets (such as mortgages) of almost $103 billion that have been securitised being brought back onto ADI balance sheets and requiring regulatory capital to be held against them.

As a result of these major AIFRS impacts, ADIs would need to raise a substantial volume of capital in a short timeframe to maintain capital levels and comply with APRA's prudential requirements. This could place significant stress on ADIs and the financial system generally. ADIs would be required to restructure and/or raise up to $24 billion of their highest quality capital which would, in turn, significantly increase their total ongoing servicing costs.

The adoption of AIFRS would also, in some areas, have unintended and undesirable prudential outcomes. The main adverse impacts would be:

- the capital base of ADIs would become subject to excessive volatility;
- ADIs might not hold a sufficient buffer against potential (but not certain) credit losses; and
- certain assets on ADI balance sheets might not be readily available to support an ADI in distress.

Objectives

APRA's primary objective is to establish, maintain and enforce prudential standards

and practices which ensure that, under all reasonable circumstances, financial promises made by ADIs are met within a stable, efficient and competitive financial system. Consistent with this, APRA's approach to AIFRS is to align its prudential and reporting framework as closely as possible with accounting standards, except where this would have an adverse impact on the intent and integrity of APRA's prudential framework. APRA has no choice but to deal with the potential impacts of AIFRS.

APRA's other objectives in its approach to AIFRS are to:

- ensure consistency with the recommendations of the Basel Committee;
- reduce, as much as possible, potential disruption caused by AIFRS; and
- clarify and provide guidance about APRA's prudential policies.

Identification of options

APRA has three possible options in responding to the adoption of AIFRS by the FRC.

Option 1 – Maintain the prudential and reporting framework to preserve AGAAP and not incorporate AIFRS (*status quo*)

Under this option, APRA's prudential and reporting framework would be kept in its current form and any references to Australian accounting standards in APRA's requirements would be to those standards that existed prior to 1 January 2005. This would mean that AGAAP would be preserved for APRA's prudential purposes.

ADIs would be required to apply AIFRS as the basis for their general purpose financial reports and AGAAP for APRA's prudential and reporting framework. These systems would not be compatible.

Option 2 – Amend the prudential and reporting framework to allow AIFRS to flow through fully

This option would involve APRA amending its prudential and reporting framework so that it would reflect all changes associated with the adoption of AIFRS. The prudential and reporting framework would therefore align with an ADI's general purpose financial reports.

Option 3 – Align the prudential and reporting framework with AIFRS, unless there are strong prudential reasons for departure

Under this option, APRA would align its prudential and reporting framework with AIFRS, except where this would not be consistent with the intent and integrity of the framework. The major points of departure are:

Tier 1 capital

APRA would 'de-couple' the definition of capital instruments eligible for Tier 1 capital from Australian accounting standards. This would allow certain instruments classified as liabilities under AIFRS to be included in capital. At the same time,

APRA would more clearly specify the definitions of Tier 1 capital and bring the Tier 1 limits into line with the Basel Committee's approach, clarify the loss absorption qualities applicable to eligible Tier 1 instruments and introduce more flexibility into the issuance of innovative instruments.

Securitised assets

APRA would also de-couple the assessment of securitised assets of ADIs for capital adequacy purposes from the accounting treatment of these assets.

Fair value measurement

APRA would restrict the use of fair value measurement for illiquid financial instruments (loans, receivables and other illiquid instruments) in the banking book. ADIs would also be required to eliminate for regulatory capital purposes any unrealised fair value gains and losses arising from changes in an ADI's own creditworthiness.

Provisions

On adoption of AIFRS, ADIs will not be allowed to raise general provisions for expected but not incurred loan losses. Under this option, however, APRA would require that ADIs create a general provision called a 'General Reserve for Credit Losses' as a buffer against potential (but not certain) losses which are intrinsic to the overall business of the ADI. Such a reserve would be treated as forming part of Upper Tier 2 capital.

Smaller ADIs would be required to continue following a provisioning approach prescribed by APRA.

Cash flow hedges

APRA would exclude cumulative gains and losses on cash flow hedges that are recognised directly in equity from the definition of Tier 1 and Tier 2 capital.

Property

APRA would introduce a consistent regulatory capital treatment for owner-occupied and investment property. An amount of 45 per cent of pre-tax revaluation reserves on owner-occupied or fair value gains on investment property would be allowed in Upper Tier 2 capital, subject to meeting certain reporting conditions.

Employer sponsored defined benefit superannuation funds

APRA would not recognise a defined benefit superannuation fund surplus as an asset for capital purposes, unless an employee sponsor is able to demonstrate unrestricted and unfettered access to the fund surplus in a timely manner.

Impact analysis

Impact group identification

APRA anticipates that the following groups would be affected by amendments to the prudential and reporting framework for ADIs in light of the adoption of AIFRS:

- APRA;
- ADIs;
- beneficiaries; and
- external users of prudential data, including Government or regulatory bodies such as the Australian Bureau of Statistics (ABS) and the Reserve Bank of Australia (RBA), and ratings agencies.

Assessment of costs and benefits

Option 1 – Maintain the prudential and reporting framework to preserve AGAAP and not incorporate AIFRS (*status quo*)

Benefits

APRA

APRA would incur no costs under this option, as changes would not be required to its existing prudential and reporting framework. Since APRA's regulatory capital requirements for ADIs would remain unchanged, the integrity of the prudential framework would be unaffected and beneficiaries would continue to receive the protection afforded by current levels of capital.

ADIs

Maintaining the *status quo* would not require ADIs to revise existing prudential reporting systems in response to AIFRS. This may also reduce potential disruption to an ADI already making significant system changes to accommodate new AIFRS general purpose financial reporting requirements.

As regulatory capital requirements would remain unchanged, ADIs would not incur costs associated with having to raise additional capital. Further, the need to commit additional resources for training, documentation, business strategy and reporting would be avoided as the prudential and reporting framework would remain changed.

Beneficiaries

As noted above, beneficiaries would continue to receive the same levels of capital protection afforded under the existing regime.

External users of prudential data

As the basis for APRA's published data would be unchanged under this option, users

would not incur costs associated with revising their analytical reports. Users would also not have to familiarise themselves with new APRA reports.

Costs

One-off and ongoing costs would differ in quantum, nature and frequency for the different impact groups under this option. In many instances, quantification of impacts would be unreliable. In these situations, APRA has instead illustrated the effects in qualititative terms.

APRA

It is unlikely that APRA would incur any direct costs, since the existing prudential and reporting framework would remain unchanged. However, it is likely that significant indirect costs may result.

Under this option, APRA would impose a significant administrative burden on ADIs in having to comply with two very different reporting regimes i.e. regulatory reporting and general purpose financial reporting. The problems of a dual reporting framework would compound over time as AIFRS matures and moves further away from APRA's prudential requirements.

Under this dual reporting environment, APRA’s prudential activities would be impeded by difficulties arising from attempting to compare an ADI's general purpose financial reports to reports submitted under the prudential regime. Prudential reports would have a substantially different basis to general purpose financial reports, making APRA's supervisory task more complicated and resource intensive. Peer group comparisons with ADIs in other jurisdictions would also become more difficult since prudential regulators in these jurisdictions are adopting IFRS (with adjustments) as the basis for their regulatory reporting.

ADIs

Under a dual reporting environment, ADIs would be required to maintain their old AGAAP reporting system to meet APRA’s requirements and, at the same time, implement system changes to accommodate AIFRS. ADIs would therefore incur a one-off build cost as well as ongoing maintenance costs for this dual reporting environment. In addition, ADIs would incur increased costs associated with compliance, audit and accounting controls. APRA believes that whilst one-off costs may be material to an entity, any ongoing costs should be marginal in comparison to an entity’s current operating costs. However, the quantum of these costs would depend on the unique circumstances of each ADI.

The requirement to complete two sets of reports would raise the possibility of confusion for those in the ADI responsible for preparing the reports. As a result, the ADI may incur significant one-off and ongoing training costs.

Beneficiaries

This option may result in beneficiaries incurring ongoing costs in the form of increased fees and charges if ADIs attempt to pass on the costs associated with maintaining two information systems.

External users of prudential data

Where users of prudential data also refer to general purpose financial reports, they may incur additional one-off and ongoing costs in maintaining different analytical frameworks to reflect the different content of the two reports. This would increase complexity in analysis and may also result in increased system and training costs. For the reasons discussed above, APRA's prudential data would lose international comparability and could be a source of confusion.

The data collected by APRA may also be inappropriate for the purposes of the ABS and the RBA since the data would be based on the superseded AGAAP accounting standards. This would result in additional one-off and ongoing costs associated with the need to manipulate the data from APRA, and could reduce the consistency of ABS and RBA reports.

Option 2 – Amend the prudential and reporting framework to allow AIFRS to flow through fully

Benefits

APRA

Under this option, APRA would be required to commit only minimal resources to make minor changes to the prudential and reporting framework. These changes would only be to remove paragraphs inserted into prudential requirements in late 2004 to preserve the link to the then-existing accounting standards. APRA's prudential and reporting framework would be fully aligned with AIFRS from that point forward.

Prudential reports would therefore closely mirror general purpose financial reports, helping to avoid confusion and making APRA's reports more transparent and easier to understand.

ADIs

Under this option, there would be no differences between general purpose financial reports and the prudential reporting framework. If further amendments were to be made to AIFRS, the prudential and reporting framework would change automatically, meaning that all financial and regulatory reports would continue to be fully aligned.

ADIs would not have to maintain two information systems, making the transition to AIFRS more manageable. Further, if the accounting standards were to change in the future, the upgrade to ADIs' general ledgers that would be required would enable them to comply with both their general purpose reporting and prudential reporting obligations.

Beneficiaries

This option is unlikely to result in costs that may potentially be passed onto beneficiaries, because ADIs would not need a separate information system to meet APRA's requirements.

External users of prudential data

Users of general purpose financial reports would have little difficulty in comprehending prudential data because of their common AIFRS basis. There would be fewer difficulties around the interpretation of the data and less training needed for staff.

Compared to Option 1, APRA's prudential data would be more readily comparable with data from jurisdictions that have adopted IFRS. However, comparability would not be complete because prudential regulators in these jurisdictions have not passed IFRS fully through to their prudential and reporting requirements.

Costs

One-off and ongoing costs would differ in quantum, nature and frequency for the different impact groups under this option. In many instances, quantification of impacts would be unreliable. In these situations, APRA has instead illustrated the effects in qualititative terms.

APRA

As mentioned above, there is significant variance between AGAAP and AIFRS requirements applicable for reporting periods beginning on or after 1 January 2005. APRA's current prudential framework relies on AGAAP, based on a decision taken in late 2004 to preserve the link to those standards until APRA could undertake a detailed assessment of the impact of AIFRS.

APRA has now completed that assessment and has concluded that the full flow-through of AIFRS to its prudential and reporting framework would, in some areas, have unintended and undesirable prudential outcomes. These were set out in the 'Problem identification' section above. These outcomes would affect the intent and integrity of the framework and reduce APRA's ability to protect beneficiaries effectively. As a consequence, APRA's reputation could also suffer on an ongoing basis.

If this option were introduced, APRA's prudential and reporting framework would be out of line with the approach of prudential regulators in major jurisdictions, who are not allowing the full flow-through of IFRS. APRA would also be out of line with the recommendations of the Basel Committee.

Under this option, APRA would incur one-off costs associated with the minor changes to the prudential and reporting framework needed to remove the link to AGAAP introduced in late 2004. It would also incur ongoing costs in the form of training for APRA's supervisory and technical support staff to apply the AIFRS requirements.

ADIs

As outlined above, the introduction of AIFRS would, on its face, result in a lower measured regulatory capital base for a number of ADIs. The two major reasons are:

- the introduction of a stricter definition of equity under AIFRS would result in certain financial instruments currently classified as equity being reclassified as

liabilities. If left unadjusted, the Tier 1 capital position across the ADI industry would be reduced by approximately $15 billion; and

- AIFRS brings back 'on balance sheet' securitised financial assets (such as securitised mortgages) of almost $103 billion. Additional capital of as much as $8.5 billion would be required to be held against these assets to meet APRA's requirements.

As a consequence, ADIs would be required to rapidly restructure and/or raise up to $24 billion of their current capital base, which in turn would significantly increase their total ongoing capital servicing costs. The ongoing costs to industry could be as high as $1.5 billion per annum, in perpetuity. Many ADIs would need to raise a substantial volume of capital in a short timeframe to meet regulatory capital requirements. This could place significant stress on ADIs and the financial system generally. There would be significant one-off costs in raising this capital, such as legal fees, corporate advisory services, underwriting arrangements and producing and disseminating disclosure documents. The quantum of these costs would differ across individual ADIs and would depend on the nature of capital raisings undertaken.

The competitive position of ADIs operating internationally would also be undermined if APRA's regulatory capital requirements were higher than in jurisdictions where prudential regulators have not allowed the full flow-through of IFRS.

Beneficiaries

To the extent that the strength of APRA's prudential and reporting framework is undermined by this option (for the reasons given above), the risks of financial loss for beneficiaries would increase. On the other hand, they would have the protection of higher regulatory capital requirements resulting from the AIFRS treatment of equity and securitised assets.

External users of prudential data

Users of prudential data familiar with AIFRS general purpose financial reports would incur no additional costs to understand these data. However, because these data are not comparable internationally, users wishing to conduct peer group analysis would incur education costs to understand the differences between AIFRS and IFRS adopted in other jurisdictions.

Option 3 – Align the prudential and reporting framework with AIFRS, unless there are strong prudential reasons for departure

Benefits

APRA

Under this option, APRA would align its prudential and reporting framework as closely as possible with AIFRS, except where this would not be consistent with the intent and integrity of the framework. The major points of departure were summarised above.

This option would allow APRA to meet its objective of basing its prudential and

reporting framework on AIFRS, while maintaining a sound and robust prudential and reporting framework that both meets its statutory objectives and recognises the realities of the ADI industry. It would also bring APRA more into line with the recommendations of the Basel Committee and the approach of prudential regulators in other jurisdictions.

ADIs

This option would ensure that ADIs would be able to continue operating in a sound regulatory environment, enhancing public confidence in the prudential regime. In particular, ADIs would not have to raise costly additional capital to compensate for the AIFRS treatment of equity and securitised assets. APRA's approach to Tier 1 capital would continue to reflect the substance of capital instruments and the reasons why prudential regulators have been prepared (within strict limits) to accept them as Tier 1 capital.

In addition, bringing APRA's approach more into line with internationally regulatory approaches would alleviate any competitive disadvantage that ADIs operating internationally might suffer because of differences in regulatory capital requirements.

Beneficiaries

Beneficiaries would benefit from the protection of a sound and robust prudential framework that has dealt with the main adverse impacts of AIFRS.

External users of prudential data

As the prudential and reporting framework would be largely in line with both AIFRS and international regulatory approaches, APRA's prudential data would be readily comparable with peer group data abroad and could be incorporated into analytical reports without difficulty.

Costs

One-off and ongoing costs would differ in quantum, nature and frequency for the different impact groups under this option. In many instances, quantification of impacts would be unreliable. In these situations, APRA has instead illustrated the effects in qualititative terms.

APRA

APRA would incur one-off costs associated with amending the prudential and reporting requirements to incorporate the points of departure from AIFRS. This option would also involve ongoing costs in training for APRA staff to ensure that the new requirements are appropriately applied. These costs would be easily absorbed in APRA's current budget.

ADIs

Under this option, ADIs would incur additional one-off and ongoing costs associated with compliance with APRA's new requirements, including staff training, amendments to information systems and changes to procedures and controls. APRA

believes that the costs associated with this option would be significantly less than Option 1, since ADIs would only have to supplement their information systems in those areas where the reporting framework diverges from AIFRS.

Beneficiaries

Beneficiaries may incur ongoing costs in the form of increased fees and charges if ADIs attempt to pass on the costs associated with maintaining two information systems. However, the quantum of these costs would be lower than Option 1 since the differences between the two reporting frameworks would be limited.

External users of prudential data

The costs to external users would be similar in type, but much smaller in quantum, than the costs outlined under Option 1 above.

Consultation

APRA undertook extensive consultation on its approach to AIFRS across the ADI industry over an 18-month period. Submissions were received from and discussions held with a number of ADIs and industry bodies such as the Australian Bankers' Association. APRA also consulted with the RBA and ABS in the development of its regulatory reports and feedback from these agencies has been incorporated in the final set of prudential reports.

This extensive consultation process was aimed at ensuring that APRA's approach to AIFRS would maintain the integrity of the prudential regime, was communicated clearly to industry and took into account practical implementation issues.

Five public consultation papers were released over the 18-month period:

- **November 2004**: *Adoption of IFRS – Prudential Implications* provided an overview to assist APRA-regulated institutions in assessing the prudential impact and associated risks of IFRS;

- **February 2005:** *Adoption of International Financial Reporting Standards: Prudential Approach 1. Fair value and other issues* outlined how APRA proposed to address the prudential implications of a number of specific AIFRS-related changes;

- **August 2005**: *Adoption of International Financial Reporting Standards: Prudential Approach 2. Tier 1 Capital and Securitisation* dealt with the treatment of eligible Tier 1 capital instruments and securitisation in the context of AIFRS;

- **November 2005**: *Response to Submissions: Adoption of International Financial Reporting Standards Prudential Approach 1. Fair Value and Other Issues* addressed issues raised by respondents on APRA's proposed prudential approach to fair value and other AIFRS issues. This paper was accompanied by draft prudential standards, guidance notes and reporting standards which provided details of the proposed changes; and

- **April 2006:** *Response to Submissions: Adoption of International Financial Reporting Standards: Prudential Approach 2. Tier 1 Capital and Securitisation* addressed issues raised by respondents on APRA's proposed prudential approach to Tier 1 capital and securitisation. This paper was also accompanied by draft prudential standards and guidance notes detailing the proposals.

The considerable feedback received from industry was particularly useful in ensuring that APRA's approach to AIFRS is appropriate to the realties of the ADI industry. Industry generally supported APRA's proposal to de-couple the definition of capital instruments eligible for Tier 1 capital as well as securitisation transactions from the AIFRS treatment. At the same time, it raised issues about APRA's proposed changes to the limits on Tier 1 capital and about the detail of some of the draft requirements. APRA considered these issues in the development of the final requirements. Submissions also made additional proposals on certain items, which were accepted by APRA.

Conclusion and recommended option

Option 3 is the preferred option.

Option 3 most effectively meets APRA's objectives, as set out above. It is a measured approach that ensures that APRA aligns its prudential and reporting framework closely with AIFRS, thus minimising the dual reporting burden for ADIs, while negating the substantial adverse implications for an ADI's capital base if the full flow-through of AIFRS were to occur.

APRA believes that this option would result in a more robust prudential regime that better protects the interests of beneficiaries.

In contrast to Option 2, Option 3 involves a limited dual reporting framework. ADIs would incur costs in maintaining dual reporting requirements, although these costs are not expected to be significant because the points of departure between APRA's requirements and AIFRS are limited. More importantly, in order of magnitude terms, the costs associated with dual reporting would be dwarfed by the benefits to ADIs of not having to restructure and/or raise up to $24 billion of new capital to meet the AIFRS treatment of equity and securitised assets.

Option 3 would bring APRA's approach to AIFRS largely into line with international regulatory approaches, ensuring ready comparability of APRA prudential data with peer group data abroad.

Under Option 3, APRA would have to devote resources to amending the current prudential and reporting framework and to training staff to ensure that the new requirements are appropriately applied. It is likely that these costs would be greater than under the other two options.

Option 1 does not meet APRA's stated objectives. While the prudential and reporting framework would remain unchanged, maintaining its current integrity, it would be out of line with international regulatory approaches. Option 1 would not involve changes to regulatory capital requirements. However, it would impose a significant administrative burden on ADIs in having to comply with two very different reporting

regimes. ADIs would likely attempt to pass these costs onto beneficiaries through increased fees and charges.

Option 2 also does not fully meet the stated objectives, particularly in relation to maintaining the protection of beneficiaries. The full flow-through of AIFRS to APRA's prudential and reporting framework would, in some areas, have undesirable prudential outcomes and would result in a less robust prudential regime. For ADIs, the lower costs (compared to the other options) of a single financial and regulatory reporting regime would be substantially out-weighed by the need to raise additional capital to compensate for the AIFRS treatment of equity and securitised assets.

Implementation and review

Changes to APRA's prudential and reporting framework to incorporate its approach to AIFRS are intended to take effect from 1 July 2006. Transition arrangements will be available for all ADIs affected by APRA's approach.

APRA will provide guidance and clarification to ADIs to ensure that they are aware of the requirements that they need to meet and the implementation process.

The prudential and reporting framework for ADIs will be subject to ongoing review and amendments will be made where warranted, and after industry consultation.

Appendix 1

Major differences between AGAAP and AIFRS

AIFRS differs from AGAAP in the following main areas:

- it involves more onerous requirements for instruments to qualify as equity;
- it introduces more stringent rules governing 'de-recognition' of financial assets and a broader capture of entities that may be required to be consolidated, such as securitisation vehicles;
- it requires all derivative financial instruments to be recognised on the balance sheet and measured at fair value. In addition, it introduces strict hedge accounting requirements;
- it prohibits the recognition of 'excess of market value over net assets' (EMVONA) of life insurance subsidiaries, which was previously permitted under AASB 1038 'Life Insurance Business';
- it does not allow general provisions for expected but not incurred losses;
- it changes the measurement basis of financial assets and financial liabilities; and
- it requires the recognition on balance sheet of defined benefit fund surpluses and deficits by employer sponsors.