

## **Banking (prudential standard) determinations Nos. 5, 12, 15 of 2007**

### **EXPLANATORY STATEMENT**

**Prepared by the Australian Prudential Regulation Authority (APRA)**

*Banking Act 1959, section 11AF*

Under subsection 11AF(1) of the *Banking Act 1959 (the Act)*, APRA has the power to determine standards (*prudential standards*), in writing, in relation to prudential matters to be complied with by authorised deposit-taking institutions (*ADIs*) and authorised non-operating holding companies (*authorised NOHCs*). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 11 December 2007, APRA made the following determinations under section 11AF:

1. Banking (prudential standard) determination No. 5 of 2007, which revokes *APS 112 Capital Adequacy: Credit Risk (existing APS 112)* (as determined by Banking (prudential standard) determination No. 5 of 2006 to take effect on 1 July 2006) and determines a new *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)*;
2. Banking (prudential standard) determination No. 12 of 2007, which determines *Prudential Standard APS 150 Basel II Transition (APS 150)*; and
3. Banking (prudential standard) determination No. 15 of 2007, which revokes *Prudential Standard APS 221 – Large Exposures* (as determined by banking (prudential standard) determination No. 8 of 2006 to take effect from 1 July 2006) and determines a new *Prudential Standard APS 221 Large Exposures (APS 221)*.

APRA has determined that the above instruments will come into force on 1 January 2008.

### **1. Background**

The international banking industry has changed dramatically since the introduction of the 1988 Basel Capital Accord developed by the Basel Committee on Banking Supervision (**Basel Committee**) to align the capital requirements of banks that compete across national boundaries. The Accord's 'one-size-fits-all' approach has been unable to deal with the increasing innovation and sophistication of the market place. The new Basel II capital adequacy regime, known as the Basel II Framework (**the Framework**), seeks to harness as part of the regulatory process, best practices in risk management. By providing a spectrum of options for calculating an authorised deposit-taking institution's minimum regulatory capital for a variety of risks, the capital requirements are both more comprehensive and risk-sensitive. These options range from relatively simple approaches to sophisticated approaches that rely more heavily on an ADI's own quantitative risk estimates.

As well as Basel II, another key policy priority for APRA has been the development of a framework of prudential supervision for conglomerate groups that include an

ADI, in line with the international trend in prudential supervision promoted by the Joint Forum on Financial Conglomerates. In November 2002, APRA released draft prudential standards that proposed a number of amendments to capital adequacy requirements to deal with ADI membership of conglomerate groups (draft conglomerate standards). The amendments were originally intended to take effect from 1 January 2007 but were deferred to 1 January 2008 to coincide with the implementation of Basel II in Australia. Since the release of the draft conglomerate standards, a number of the amendments have been incorporated in the existing APS 110 and the existing APS 111 as part of other changes to these standards. Many of the remaining amendments were Basel II specific are now proposed to be implemented as part of Basel II.

## **2. Purpose and operation of the instruments**

*Banking (prudential standard) determination No. 5 of 2007*

The purpose of the instrument is to revoke the existing APS 112 and the related guidance notes and to replace them with a new APS 112 which contains the capital adequacy requirements for the standardised approach to credit risk. As the adoption of the Framework involves major changes to APS 112, APRA is of the view that it is appropriate to revoke and replace the existing prudential standard.

The new APS 112 applies to all ADIs other than foreign ADIs and ADIs that have approval to use an internal ratings-based (IRB) approach to credit risk under APS 113. In addition, where an ADI to which the standard applies is a subsidiary of an authorised NOHC, the authorised NOHC will be responsible for ensuring that the members of the relevant Level 2 group collectively comply with the requirements of the Prudential Standard.

APS 112 covers the standardised approach to credit risk. The majority of Australian banks, building societies and credit unions will use the standardised approach to credit risk for capital adequacy purposes. While the new APS 112 has some similarities to the current prudential standard for credit risk, there are a number of key differences. These include:

- the removal of the OECD/non-OECD grouping for sovereign and bank exposures with risk-weights based instead on ratings issued by external credit assessment institutions;
- lower risk-weights for exposures to corporate counterparties where those counterparties have an external credit assessment of 'A-' or better;
- subject to meeting minimum criteria, an expanded range of credit risk mitigation techniques comprising collateral, lenders mortgage insurance, guarantees, credit derivatives and netting;
- the introduction of a capital requirement for short-term (less than one year) undrawn commitments; and
- revised risk-weights for residential mortgage loans.

In addition to the key changes outlined above, the existing guidance notes to the current APS 112 have also been revoked. The material in these guidance notes has been incorporated in the prudential standard as attachments. The new standard has

nine attachments: risk-weights for on-balance sheet assets; credit equivalent amounts for off-balance sheet exposures; residential mortgages; unsettled and failed transactions; short-term and long-term credit ratings; guarantees; simple and comprehensive approaches to the recognition of collateral; credit derivatives in the banking book; and netting.

*Banking (prudential standard) determination No. 12 of 2007*

The purpose of the instrument is to determine APS 150 which contains transitional capital adequacy requirements for ADIs that have sought or have approval by APRA to adopt the advanced approaches to credit and operational risks under APS 113 and APS 115.

In addition, where an ADI to which the standard applies is a subsidiary of an authorised NOHC, the authorised NOHC will be responsible for ensuring that the members of the relevant Level 2 group collectively comply with the requirements of the prudential standard.

The advanced approaches to credit and operational risks for capital adequacy purposes under the Framework are as yet not fully tested. Accordingly, the Framework believes that it is appropriate for supervisors to apply prudential floors in the transition period to ensure that the implementation of ADIs' advanced approaches is sound.

The key requirements of APS 150 are that an ADI that has:

- IRB/AMA accreditation is subject to a transitional floor adjusted risk-weighted assets calculation in accordance with the prudential standard; and
- a pending IRB and/or AMA accreditation and has applied to APRA to continue reporting under Basel I prior to accreditation, may seek APRA's approval to hold capital in accordance with the Basel I capital standards until the ADI has received both an IRB and an AMA accreditation.

*Banking (prudential standard) determination No. 15 of 2007*

The purpose of the instrument is to revoke and replace APS 221 to incorporate certain technical amendments reflecting changes made to other prudential standards applying to ADIs as a result of the adoption of Basel II in Australia. This will ensure the accuracy of cross-references between prudential standards and to make other minor drafting amendments.

### **3. Consultation**

APRA undertook extensive consultation on its proposed adoption of the Basel II Framework in Australia between early 2005 and mid 2007. Submissions were received from, and discussions held with, numerous ADIs and industry bodies, external credit rating agencies and other interested parties.

This extensive consultation process was aimed at ensuring that the adoption of Basel II would maintain the integrity of the prudential regime whilst remaining relevant to industry. The consultation also ensured clear communication with industry on the main changes proposed and took into account practical implementation issues.

A number of public discussion and response papers (with draft standards) were

released during the consultation period:

- April 2005: *Implementation of the Basel II Capital Framework 1. Standardised approach to credit risk;*
- July 2005: *Implementation of the Basel II Capital Framework 2. Standardised approach to operational risk;*
- July 2005: *Implementation of the Basel II Capital Framework 3. Internal ratings-based approach to credit risk;*
- October 2005: *Implementation of the Basel II Capital Framework 4. Advanced measurement approaches to operational risk;*
- March 2006: *Implementation of the Basel II Capital Framework 5. Interest rate risk in the banking book;*
- October 2006: *Implementation of the Basel II Capital Framework 1. Advanced measurement approaches to operational risk - Response to submissions;*
- November 2006: *Implementation of the Basel II Capital Framework 6. Securitisation and the standardised approach to credit derivatives in the banking book;*
- June 2007: *Implementation of the Basel II Capital Framework 7. Market Disclosure;*
- June 2007: *Implementation of the Basel II Capital Framework 2. Advanced approaches to credit risk, operational risk and interest rate risk in the banking book - Response to submissions;*
- July 2007: *Implementation of the Basel II Capital Framework 3. Securitisation - Response to submissions;*
- July 2007: *Implementation of the Basel II Capital Framework 4. Standardised approaches to credit risk and operational risk - Response to submissions;* and
- August 2007: *Implementation of the Basel II Capital Framework 8. Market risk.*

Industry feedback was particularly useful in ensuring that APRA's approach to the adoption of the Basel II Framework is appropriate to the operations of the domestic ADI industry. APRA has considered the issues raised by industry and other interested parties in the development of the final set of prudential standards.

The proposals relating to prudential supervision of conglomerates groups were originally released for public comment in late 2002. A final period of consultation with industry and other interested stakeholders was undertaken in mid 2007. This consultation involved the release of a discussion paper on aspects of the proposed changes to the capital prudential standards. In addition, the proposed amended standards were made available for viewing and comment on the APRA website.

APRA, after considering the comments made, has modified certain provisions in the prudential standards to improve the clarity of the requirements. A number of submissions requested that APRA provide further guidance on various matters set out

in the prudential standards. In response to these requests for guidance, APRA will accompany a number of the new Basel II standards with prudential practice guides to assist ADIs with interpretation and application issues raised in submissions or which may come to light upon implementation.

#### **4. REGULATION IMPACT STATEMENT: ADOPTION OF THE BASEL II CAPITAL FRAMEWORK IN AUSTRALIA**

##### **Executive summary**

Prior to APRA finalising its decision to implement the Basel II Capital Framework, a Regulation Impact Statement (**RIS**) was prepared providing a consistent, systematic and transparent process for assessing the alternative policy approaches available. The RIS included an assessment of the impacts of Basel II and the alternatives on different stakeholder groups and on the community as a whole.

This RIS ensures that all relevant information is presented to the APRA Members when deciding whether to finalise APRA's prudential standards to implement Basel II in Australia. This RIS updates the previous decision-making RIS and its format closely mirrors that of the original.

##### **Background**

The Basel Committee on Banking Supervision (**the Basel Committee**) provides a forum for regular co-operation on banking supervisory matters. Its members come mainly from G-10 central banks and prudential supervisory authorities. The Basel Committee operates under the auspices of the Bank for International Settlements with the objectives of enhancing understanding of key supervisory issues and improving the quality of banking supervision worldwide. Where considered desirable, it develops guidelines and supervisory standards.

In 1988, the Basel Committee released a capital adequacy measurement system commonly referred to as the Basel Capital Accord (**the Accord**). The Accord has been progressively introduced not only in the G-10 countries, but in almost all other countries and it is commonly applied to all banks, not just those that are internationally active. It is based on a simple risk-weighting scheme for on-balance sheet and off-balance sheet credit risk (0 per cent for government, 20 per cent for banks, 50 per cent for eligible housing loans and 100 per cent for other exposures); subsequently, a small add-on was included for traded market risk. The Accord was the first step in moving from a simple capital-to-assets ratio to a methodology whereby banks held capital that was better aligned to risk. Basel II is the next major step towards better aligning risk and regulatory capital.

Australia was an early adopter of the Accord, reflecting the sophistication of the Australian banking system and its prudential supervision. The existing Australian prudential standards relating to capital adequacy, made pursuant to section 11AF of the *Banking Act 1959*, are based on the Accord and apply to all of the 184 authorised deposit-taking institutions (ADIs) - banks, building societies and credit unions - that are not branches of foreign-owned banks and are supervised by APRA.

As well as Basel II, another key policy priority for APRA has been the development of a framework of prudential supervision for conglomerate groups that contain an ADI. APRA's approach to conglomerate supervision is in line with the international trend in prudential supervision as promulgated by the Joint Forum on Financial

Conglomerates. In November 2002, APRA released draft prudential standards which implemented a number of amendments to capital adequacy requirements to deal with ADI membership of conglomerate groups (**draft conglomerate standards**). The amendments were originally intended to take effect from 1 January 2007 but were deferred to 1 January 2008 to coincide with the implementation of Basel II in Australia. Since the release of the draft conglomerate standards, a number of the amendments have been incorporated in *Prudential Standard APS 110 Capital Adequacy (APS 110)* and *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)* as part of other changes to those standards.

### **Problem identification**

Capital provides a buffer to strengthen the safety and soundness of ADIs. It is intended to absorb unanticipated losses from an ADI's activities and, in the event of problems, enable an ADI to continue operating while those problems are addressed or resolved. It also serves as a benchmark against which the financial condition of an ADI can be measured.

Capital adequacy rules are therefore an essential component of a healthy financial system and are crucial to the prudential supervision of ADIs. Accordingly, APRA has in place prudential standards on capital adequacy which include the measurement of capital.

With the introduction of the Accord in 1988, Australia had the option of either retaining the existing capital regime for ADIs, at least for a time, or adopting the new global standard. The decision was taken to adopt the global standard (by incorporation into the Australian prudential standards) for the following reasons:

- Australian bank prudential supervision was at world's best practice and the Accord, with its move to a more risk-based framework, was judged, both in Australia and overseas, to be an improvement on the simple capital ratios then used. Failure to adopt the Accord (in Australia) was regarded as a backward step;
- several Australian banks had significant overseas operations that may have been adversely impacted if relevant host supervisors considered Australian prudential supervision to be less than best practice. Imposing a different regulatory framework would also have increased compliance costs for those banks; and
- the Government had only recently granted a number of new banking authorities with a view to increasing competition. Several of those new authorities had been granted to the Australian subsidiaries of foreign banks. To subject those subsidiaries to a different regulatory capital regime from that applied to their parent entities may have led to distortions in the competitive environment the Government was attempting to foster.

Since the introduction of the Accord, there has been substantial change in global financial markets and developments in risk measurement and management techniques. From the early 1990s onwards, more sophisticated banks have adopted, for their own internal purposes, economic capital models. These models estimate the capital required to limit the probability of financial failure for a given bank, using that bank's

actual risk position rather than the standard assumptions used for regulatory capital rules. This has been possible as a consequence of improved risk management and measurement practices as well as vastly improved data management technology.

In light of these developments, the Accord came under growing criticism for its inability to deal with the increasing innovation and sophistication in the marketplace as it relies on a relatively broad-brush ‘one-size-fits-all’ approach. That led to the Basel Committee developing the new Basel II capital adequacy regime. Basel II aims to better align regulatory capital with the individual risk profiles of banking institutions; a bank with greater exposure to risk than its peers will hold more capital, while one exposed to less risk will hold less capital.

### **The Basel II Capital Framework**

Basel II consists of three mutually reinforcing pillars: minimum capital requirements (**Pillar 1**), the supervisory review process (**Pillar 2**) and increased disclosure requirements (**Pillar 3**).

Pillar 1 directly replaces the requirements of the Accord and sets out the revised methodology for the minimum capital adequacy calculation. Basel II provides a more comprehensive and more risk-sensitive approach (covering credit risk, market risk and operational risk). For each category of risk, there is a hierarchy of approaches for calculating the minimum capital requirements. These approaches can be broadly grouped into the simpler (standardised) approaches and the more sophisticated modelling-based (advanced) approaches, which rely on an ADI’s own internal risk-assessment and measurement methodologies.

For credit risk, the standardised approach under Basel II is similar in methodology to the (existing) Accord. Basel II, however, adopts a more granular approach (i.e. uses more ‘risk buckets’). For ADIs with adequate internal credit rating systems, Basel II also provides for two model-based approaches. Under Basel II, the capital charge for traded market risk remains essentially unchanged and there is a new explicit capital charge for an ADI’s operational risk.

The Basel Committee has also specifically identified interest rate risk in the banking book (**IRRBB**) as a potentially significant risk that merits support from capital. National supervisors have discretion to include capital requirements relating to IRRBB as part of either Pillar 1 or Pillar 2. APRA has exercised this discretion and set Pillar 1 mandatory minimum capital requirements for IRRBB to be applied to banks accredited to adopt the advanced approaches.

Pillar 2 addresses supervisory review and sets out four key principles:

- banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels;
- supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the process;



- supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to make banks hold capital in excess of the minimum; and
- supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required.

The aim of Pillar 3 is to encourage market discipline through materially increased disclosure requirements. It is intended to complement Pillars 1 and 2 by allowing market participants to assess key pieces of information on the capital adequacy and risk assessment processes of an institution.

As part of the Basel Committee's objective of establishing a more risk-sensitive framework for determining regulatory capital requirements, Basel II includes a number of 'national discretions'. These discretions range from technical aspects of implementation to the risk-weights to be applied to certain credit exposures and the methodologies to be applied in calculating operational risk. They allow supervisors to tailor requirements to reflect local industry conditions and practices (such as those in the banking, legal and accounting areas).

In line with the preferences of both APRA and the industry, APRA released its discretions progressively as they were determined in order to facilitate industry to comment and better prepare for the implementation of Basel II. Basel II requires that the discretions be determined on a national basis and not at the individual institutional level (refer to the Attachment to this RIS).

As part of the process of implementing the Basel II Framework in Australia, changes are proposed to other APRA capital adequacy prudential standards. These changes aim to extend the definitions of Level 1 and Level 2 for capital adequacy purposes, implement the Basel II 50 per cent Tier 1 / 50 per cent Tier 2 approach for capital deductions and implement the Basel II requirement that identified capital shortfalls in selected non-consolidated subsidiaries of an ADI be deducted from the capital of the consolidated banking group, amongst other changes.

### *Objectives*

By adopting Basel II (including the selected national discretions) in Australia, APRA's objectives are to:

- better align regulatory capital requirements with the individual risk profiles of ADIs;
- align Australian prudential standards with international guidelines (in particular, Basel II); and
- as appropriate, make use of available national discretions to better reflect local conditions and practices.

### *Identification of Options*

**Option 1 – Retain the existing prudential standards on capital adequacy for**

## **ADIs.**

Under this option, Basel II would not be implemented in Australia and the existing Accord would continue to apply. It would retain the simple risk-weighting scheme outlined previously. The capital prudential standards would also not be updated to allow an appropriate level of prudential supervision of conglomerate groups that include an ADI.

*Option 2 – Modify the prudential standards in line with Basel II including the appropriate national discretions.*

Under this option APRA would adopt Basel II in Australia and exercise national discretions where considered appropriate. The Basel Committee's capital adequacy guidelines are designed to provide more accurate alignment with the individual risk profiles of institutions, lessen regulatory arbitrage opportunities and offer greater flexibility for supervisors to recognise/encourage the use of more sophisticated risk management techniques (where appropriate).<sup>1</sup> While Basel II focuses primarily on internationally active banks, the underlying principles are also intended to be suitable for application to institutions of varying levels of complexity and sophistication.

### **Impact analysis**

Any changes to the prudential standards for capital adequacy, reflecting the implementation of Basel II, would affect ADIs, depositors, borrowers and APRA.

#### *Assessment of Costs and Benefits*

### **Option 1 – Retain the existing prudential standards on capital adequacy for ADIs.**

This was a genuine option at the time the original decision-making RIS was prepared. However, it is now clear that the move to Basel II is supported by ADIs and no commentators on APRA's draft Basel II prudential standards argued for retention of the original Accord. Further, with the passage of time, both APRA and ADIs have expended considerable resources in preparing for the implementation of Basel II. There would be no return on the expenditure of those resources were the existing prudential standards on capital adequacy to be retained. For completeness, however, Option 1 is again considered in this decision-making RIS.

## ADIs

### *Benefits*

Under this option, there would be no change in capital adequacy requirements for ADIs. Thus, there would be no costs associated with changing the systems used to

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<sup>1</sup> A detailed set of reform proposals was released by the Basel Committee in January 2001, with further updates released in April 2003 and November 2005. A comprehensive version of the revised framework was released in June 2006.

measure, monitor and report ADIs' regulatory capital ratios and, for those ADIs with a (comparatively) higher risk profile, no costs associated with raising additional capital.

#### *Costs*

Retaining the existing framework may result in the following costs:

- Australian ADIs with international operations may be subject to a competitive disadvantage relative to their international peers operating under Basel II, in terms of regulatory treatment, access to markets and cost of funding;
- foreign bank branches operating in Australia would potentially be operating at a competitive advantage compared to all Australian ADIs, whether or not they are internationally operating, as the foreign banks will be subject to a more risk-sensitive regulatory capital regime that, for less risky business, will require less regulatory capital; and
- ADIs with a (comparatively) lower risk profile, may potentially forego a reduction in regulatory capital.

#### Depositors

##### *Benefits*

Under this option, the benefit to depositors would be unchanged from the current position.

##### *Costs*

The cost to depositors of this option is that the potential for improved prudential regulation from the use of a more risk-sensitive regulatory framework, including the holding of capital that is better aligned to risk (and hence better protection for depositors), would not be realised.

#### Borrowers

##### *Benefits*

Under this option, the benefit to borrowers would be unchanged from the current position.

##### *Costs*

As the creditworthiness of borrowers is not factored into capital requirements using best practice techniques, more creditworthy borrowers may pay a higher interest rate than is required to appropriately reflect their creditworthiness.

#### APRA

##### *Benefits*

Under this option, APRA would not incur the costs associated with modifying the existing regulatory capital regime. Such costs include those associated with the effort and resources necessary to develop the new standards, internal and external training and education, and changes to supervisory processes.

#### *Costs*

Retention of the existing regulatory capital framework results in a less risk-sensitive approach to determining capital requirements. The cost of this option is that the improvements associated with Basel II - such as closer alignment of risk with regulatory capital leading to improved protection of depositors' interests and financial system safety - would be foregone.

This option would potentially result in APRA being viewed adversely by the international community of banking supervisors as the Australian regime would be seen to be below best practice and not aligned with international standards. This would be especially so given the sophistication of the Australian market.

*Option 2 – Modify the prudential standards in line with Basel II including the appropriate national discretions.*

#### *Some general observations*

The larger Australian banks are among the global banks that commenced developing sophisticated risk management systems and internal economic capital models prior to the release of Basel II. This gives those banks a foundation on which to base the advanced Basel II methodologies. The small ADIs do not have the resources, or indeed the need, to implement the advanced approaches and will implement the standardised approaches.

A small number of banks ranked behind the four majors in terms of asset size have also indicated a desire to implement the advanced approaches. Any such decision must be made by an ADI's board and management team. APRA's role is to assess the applications for accreditation to use these approaches.

A simple scenario (a \$100 loan to a corporate entity) can be used to illustrate the impact of moving from the Accord to the standardised Basel II approaches.

No	Loan amount	Rating	Risk-weight	Credit risk charge	Operational risk charge	Total capital charge
<b>Accord</b>						
1	\$100	N/A	100%	\$8.00 [\$100*100%*8%]	N/A	\$8.00
<b>Basel II</b>						
2	\$100	AA	20%	\$1.60 [\$100*20%*8%]	\$0.50 per \$100	\$2.10 [\$1.60+\$0.50]
3	\$100	BB-	150%	\$12.00 [\$100*150%*8%]	\$0.50 per \$100	\$12.50 [\$12+\$0.50]

Example 1 shows a capital charge calculated under the (existing) Accord, where all loans to corporate counterparties are risk-weighted at 100 per cent. A \$100 loan to a corporate entity therefore attracts a capital charge of \$8. Under the Basel II standardised approach, risk-weights are determined by the rating of the corporate entity, as assessed by ratings agencies such as Moody's or Standard & Poor's. In example 2, the corporate entity is rated AA, resulting in a credit risk capital charge of \$1.60. In example 3, the corporate entity is rated BB-, resulting in a credit risk capital charge of \$12.50.

Under Basel II, in conjunction with the credit risk capital charge, there is a direct capital charge for operational risk, with a number of methods for its calculation. Basel II recognises that operational risk occurs at the institutional level, not in relation to individual credits; however, for an ADI adopting the standardised approach, a typical charge can be approximated at \$0.50 per \$100 of assets. The \$100 loan to a corporate entity that required the ADI to hold \$8 of capital under the Accord (refer to example 1) would, under Basel II, require the ADI to hold total capital between \$2.10 (refer to example 2) and \$12.50 (refer to example 3), the range of variation of which is determined primarily by the creditworthiness of the borrower.

The wide variation in capital outcomes illustrated by these examples highlights the choices an ADI has in setting its risk appetite and profile. For ADIs implementing the advanced approaches, the calculation is much more complex and the variation potentially wider and significantly more granular.

Typically, an ADI will have a mix of exposures. Basel II does not seek to restrict the choices an ADI may make in setting its risk profile. Rather, Basel II aims to ensure that an ADI holds a level of capital commensurate with the risk it undertakes. As a result of the long lead-times associated with the implementation of Basel II, ADIs have had the opportunity to reassess their risk profiles and change the structure of

their books if considered appropriate.

Due to the many variables, both in terms of Basel II methodologies and the choices to be made by ADIs, it is not possible to identify with certainty which institutions will be required to hold more capital under Basel II and which will hold less. The level of capital held by each ADI under Basel II will, however, be more closely aligned to the risk to which each ADI is exposed, making ADIs and the financial system safer as a consequence. The closer alignment will also reduce short-term distortions resulting from mispricing as a consequence of holding capital that does not reflect risk. Thus, although Basel II is directed at prudential issues, it is anticipated that it will facilitate a fairer competitive environment for existing and new ADIs alike.

As with changes in the capital levels of individual ADIs, it is not possible to foreshadow the impact of Basel II on individual borrowers or classes of borrowers. Borrowers currently pay different prices (or costs) based on an ADI's assessment of risk associated with the borrower and the value the ADI places on the relationship. In making pricing decisions, ADIs take into account a variety of factors such as cash flow, net worth and collateral, all of which are borrower-specific. It is the role of the ADI, not the prudential supervisor, to make decisions on these matters. Prudential supervisors seek to ensure that ADIs properly assess, measure and manage risks and Basel II seeks to ensure that regulatory capital is aligned to those risks.

Supervisors generally impose a higher capital requirement on a new entrant in comparison to an existing ADI that is broadly equivalent in size, business mix, complexity and risk profile. This is a reflection of the risks inherent in a 'start-up'. Generally, these risks are also recognised by the boards and senior management teams of ADIs through the establishment of higher capital buffers that they project to run-down as the ADI becomes established. This treatment is unlikely to change under Basel II, notwithstanding the addition of new explicit capital charges that will apply equally to existing ADIs and new entrants.

For ADIs adopting the standardised approaches, there are set formulae for calculating new capital charges and, as a result, there is no 'specified' difference in treatment between existing and new ADIs. New entrants under the advanced approaches would better align risk to regulatory capital. Arguably, these ADIs would be required to 'specifically' hold capital against identifiable start-up risks, such as operational risks. Irrespective of the process, however, it is expected that these risks would feed into the setting of capital buffers by the supervisor and an ADI's board and management team. Thus the overall impact of Basel II on the process would be expected to be neutral.

## ADIs

### *Benefits*

The benefits of this option to ADIs include:

- for those ADIs with international operations, the introduction of Basel II in Australia would ensure that the Australian regulatory capital regime remains consistent with international best practice and is seen as such by the international business community and other market participants, including ratings agencies. This should assist Australian ADIs in continuing to have

access, at a competitive price, to international capital markets;

- Australian-incorporated ADIs would be subject to the same regulatory capital regime as foreign bank branches operating in Australia (foreign bank branches will be subject to the capital regulation in their home jurisdiction which, typically for the (Australian-domiciled) foreign bank branches, will be Basel II);
- ADIs with a lower (comparative) risk profile would most likely hold less regulatory capital than under the existing regime; and
- over time, operating costs may be reduced, particularly for those ADIs using the advanced approaches, as regulatory capital requirements would be more closely aligned with the way these banks manage themselves for their own internal purposes.

APRA has undertaken quantitative studies on the impact of Basel II on institutions adopting both the standardised and advanced approaches. There are some caveats around those studies, being primarily that ADIs proposing to adopt the advanced approaches are still finalising some of their risk estimates and, secondly, that the studies only looked at a sub-set of the ADIs adopting the standardised approaches - albeit a sub-set designed to be representative across the ADI industry. It is also the case that some ADIs may restructure the composition of their assets in anticipation of the implementation of Basel II. Nevertheless, reflecting the greater risk-sensitivity of both the standardised and advanced approaches, under Basel II there would be greater dispersion around the average capital requirement than is currently the case. Overall, it is anticipated that, on average, ADIs under both the standardised and advanced approaches will have a modest decline in their regulatory capital. Those ADIs adopting the advanced approaches will be subject to a maximum reduction of ten per cent pending a review by APRA during 2009. Those ADIs with higher risk portfolios would, of course, have to hold a higher level of regulatory capital.

#### *Costs*

Under this option, ADIs would incur costs associated with modifying their systems and processes in order to measure, monitor and report their capital adequacy position under Basel II. The costs to ADIs of implementing the advanced Basel II approaches, which are unavoidably complicated, vary significantly, depending on the extent to which existing systems have to be 'upgraded', but are considerable. In contrast, APRA is committed to minimising the costs for small ADIs adopting the standardised approaches.

As Basel II is a more risk-sensitive approach to determining regulatory capital requirements, there may be some costs incurred by those ADIs with a comparatively higher risk profile as they would be required to hold (and possibly raise) additional capital.

In addition to explicit costs, the implementation of Basel II would absorb a large amount of management time and attention, especially for those ADIs adopting the advanced approaches. APRA and the banks are alert to the possible distraction this may have on the broader roles of management and have been taking appropriate

action.

## Depositors

### *Benefits*

Application of Basel II would better align regulatory capital with an ADI's risk profile. This should provide a benefit to depositors in the form of improved depositor protection.

### *Costs*

There is potential for additional costs to depositors under this option should ADIs decide to pass on the costs of moving to the new regulatory capital regime in the form of increased fees and charges, or lower deposit interest rates. However, this is considered to be an unlikely consequence as ADIs with a lower (comparative) risk profile would be required to hold less capital, which would reduce their cost base. They may choose to pass, at least part of, the benefit of this to depositors. For those ADIs that will be required to hold additional capital, the additional costs would be borne by the less creditworthy borrowers, an entirely appropriate outcome.

## Borrowers

### *Benefits*

Under this option, borrowers would pay interest rates that more accurately reflect their creditworthiness.

### *Costs*

Less creditworthy borrowers, both large and small, may be required to pay a higher interest rate than would otherwise be the case. From both an equity and stability perspective, this is an appropriate outcome. The implementation of Basel II should not by itself impact on the availability of credit, although it would lead to that credit being more accurately priced to reflect risk.

## APRA

### *Benefits*

By ensuring regulatory capital is better aligned with an ADI's risk profile and reducing opportunities for regulatory arbitrage, the application of Basel II in Australia would promote improved safety and soundness of ADIs. This would assist APRA in discharging its mandate of prudential supervision and depositor protection.

This option would also result in the Australian regulatory capital regime for ADIs being consistent with international best practice. That would be beneficial for those ADIs accessing international markets, or those with international operations which are subject to home and host supervisory arrangements.



## *Costs*

Significant costs have been and will continue to be incurred by APRA in relation to the implementation and on-going supervision of a new regulatory capital regime. Costs include those related to development of the Australian framework, as well as the assessment of accreditation applications and on-going monitoring.

For the 2005-06 and 2006-07 financial years, APRA has spent \$4.3 million and \$4.0 million, respectively, on expenses associated with the development of the supervisory infrastructure and technical capacity required for implementation of Basel II. Much of this cost is associated with the advanced approaches. By agreement, those banks adopting the more advanced approaches have been specifically reimbursing APRA for its costs in developing and implementing those approaches

## **Consultation**

APRA has committed to ensuring that the Basel II requirements in Australia remain consistent with the international framework but also reflect local conditions and practices, where appropriate. Consultation has been an essential part of that process and ADIs and interested parties have been involved in both formal and informal consultation processes over the entire period of the development of the Australian Basel II requirements.

Over the past three years, APRA has progressively released its proposed national discretions and Basel II rules for consultation and to assist industry in preparing for the implementation of Basel II. The formal processes have involved public releases of draft prudential and reporting standards and discussion papers for comment. In most instances, a response paper and a revised draft prudential standard have also been released for comment. APRA has also consulted on the proposed prudential standard dealing with transitional arrangements with those ADIs that will be impacted by the standard. That standard is quite technical and APRA had previously made public the broad outline of the arrangements.

More specifically, following the announcement in 2003 of the intention to implement Basel II in Australia, APRA did not receive any submissions arguing against this position. Responses received from ADIs on the consultative documents released by the Basel Committee were supportive of the broad direction of the proposals. During 2005, APRA issued discussion papers and draft prudential standards addressing the standardised and advanced approaches to credit risk and operational risk.

In 2006, APRA released discussion papers and draft prudential standards on interest rate risk in the banking book (IRRBB), securitisation and details of the standardised approach to credit derivatives in the banking book. In addition, a response paper and revised draft standard on the advanced measurement approaches to operational risk were also released.

During 2007, APRA released response papers and revised drafts of prudential standards in relation to the advanced approaches to credit risk, operational risk and interest rate risk in the banking book. Response papers and revised draft standards were issued for securitisation and the standardised approaches to credit risk and operational risk. A discussion paper and draft of the market risk prudential standard

was also released. In addition, APRA released a draft prudential standard outlining the Pillar 3 disclosure requirements, a discussion paper on APRA's approach to Pillar 2 and draft Basel II reporting requirements.

The Basel II Framework, in both its standardised and advanced guises, was primarily designed for internationally operating banks. In Australia's case, the internationally operating banks signalled early in the process their intention to seek advanced status. That has allowed APRA some freedom to tailor the standardised approaches to the Australian market without raising complexity or competitive issues for those ADIs that are operating in the international market place.

The Basel Committee has sought to engender convergence of capital requirements for internationally operating banks. Within the constraints of the Australian market and its own prudential obligations, APRA has sought to make its requirements for the advanced approaches as close as possible to those of the Basel II Framework. The industry has been supportive of this approach and APRA has been able to reflect much of the commentary received on the advanced approaches in revisions made to the standards.

The broad direction of the comments and APRA's responses have been outlined either in the various response papers previously released or in the paper that will accompany release of the final prudential standards. In doing so APRA has been alert to the need to ensure the confidentiality of commentators and of ADIs. The more significant issues are outlined below.

#### *The standardised approaches*

For credit risk, one area on which there has been extensive consultation is APRA's approach to residential mortgage loans. Reflecting the relative importance of such lending in Australia, APRA has proposed a risk-weighting scheme with significantly greater granularity than contained in the Basel Committee's Basel II Framework, thus further increasing risk sensitivity. APRA's proposals also continue the existing practice of recognising the role of lenders mortgage insurance, to the extent permitted by Basel II. Further, with the exception of past due residential mortgage loans, APRA does not apply large exposure limits on the risk transfer involved when ADIs use mortgage insurance. APRA's Basel II proposals will result in a reduction in system capital that has to be held against residential mortgage lending but the reduction will be a prudentially sound one.

Basel II provides a number of approaches for applying capital against operational risk. All are based on income providing a proxy for operational risk. APRA explored the suitability of all the approaches in the Australian market and found that the Alternative Standardised Approach (ASA) provided the most appropriate outcome. The ASA uses an assumed income for retail and commercial banking based on the amount of associated loans and advances and actual income for all other business. In the interests of simplicity, APRA has also significantly reduced the number of regulatory business lines to which ADIs have to map their business activities.

It has become apparent that the business or corporate structures of some ADIs do not, at the margin, always lend themselves to the rules of the ASA. APRA has taken the details of the relevant rules out of its final prudential standard and, through guidance,

has been able to provide the flexibility to address such situations.

### *The advanced approaches*

There are two areas under the IRB approach where APRA and industry consider that more time is necessary to ensure that the risks are fully understood and the risk estimates are robust. They are the estimates for the loss on default of residential mortgage loans and margin lending. In both cases, APRA has put in place 'supervisory floors' pending further analysis and discussion with the relevant ADIs (the 'floor' for margin lending applies to both the advanced and standardised approaches.)

The Basel Committee acknowledges that IRRBB is a potentially significant risk that merits support from capital. However, because there is considerable heterogeneity across internationally active banks in terms of the nature of the underlying risk and the processes for monitoring and managing it, Basel II includes IRRBB under Pillar 2 with the option for supervisors to include it in Pillar 1 for their jurisdictions. Consistent with Basel II, APRA has established a mandatory minimum capital requirement for ADIs adopting the advanced approaches. Generally the affected ADIs have acknowledged the logic of APRA's position; however, it is recognised that banks typically manage IRRBB under a normal operating environment, whereas APRA's requirements are focused more on solvency. Submissions from industry noted that a consequence of APRA's proposals is the divergence between APRA's requirements and banks' internal processes. APRA has sought to minimise those differences to the extent possible without weakening its prudential position.

APRA has finalised its approach to securitisation against the background of the recent market turbulence affecting securitisation markets and associated ADI exposures. The Basel II requirements for securitisation have addressed most of the current inadequacies in capital regulation so, on balance, no further tightening is considered necessary. As is the case with most other supervisors, APRA is proposing to align its standards closely to the Basel II 'wording'. APRA is, however, proposing to meet one industry concern and depart from Basel II by allowing the Internal Assessment Approach methodology to be applied to non-asset backed commercial paper programs. APRA is also proposing to address industry concerns about transition arrangements by effectively delaying for six months the application of the new operational requirements and providing for a two-year transitional relief. The industry has strongly supported APRA's proposed securitisation self-assessment approach.

APRA proposes to follow closely the Basel II requirements on Pillar 3 (market discipline) in respect of the internationally operating ADIs but to simplify the requirements for the smaller domestic ADIs. The industry has generally supported this approach. Concern was expressed that APRA's proposed detailed quarterly reporting of capital would effectively result in ADIs disclosing their profits on a quarterly basis. APRA is proposing to address that concern by requiring that the detail of an ADI's capital structure be reported only for those quarters that coincide with the ADI's normal statutory reporting – semi-annually and annually for (ASX) listed ADIs and annually for unlisted ADIs. It is also proposed to allow ADIs time to prepare for Pillar 3 disclosure by not requiring it until as at the end of September 2008.

### *Capital adequacy*

In July 2007, APRA released a discussion paper and draft prudential standards setting out proposed changes to capital adequacy requirements, including the measurement of capital. The proposed changes sought to align APRA's approach to capital adequacy with the Basel II Framework and to implement changes to the capital adequacy prudential standards that had previously been announced in 2002 in the draft conglomerates standards.

Submissions primarily addressed issues of clarification and interpretation. Changes have been made to the prudential standards to respond to those issues. APRA also intends to address some of the issues raised through prudential practice guides that would outline APRA's approach to the implementation of prudential standards relating to capital adequacy.

A few submissions raised concerns about the proposed deduction of capital support arrangements from Tier 1 and Tier 2 capital. Submissions suggested the application of this requirement was too broad. In response, APRA has narrowed its application and has made it more principles-based. Some other submissions discussed the impact of certain other proposed deductions from capital on their individual circumstances. APRA has reviewed all deductions to ensure their appropriateness and, where considered appropriate, has modified the wording in the prudential standards to take account of issues raised in the submissions.

### **Conclusion**

Basel II is generally accepted as a major global advance in fostering improved risk management practices within ADIs and in prudential supervision of ADIs. Its implementation will represent a new benchmark for determining the capital adequacy requirements supervisors set for ADIs.

Three main factors have been considered in determining which option represents the most appropriate regulatory capital regime for Australian ADIs:

- firstly, as Australia has a sophisticated financial system, general market participants and observers expect the regulatory capital regime to be aligned with international best practice. This expectation is consistent with Government policy to position Australia as a global financial services centre in the Asia-Pacific region;
- secondly, the Australian banking industry is supportive of the Australian regime being based on best practice and international standards. Australia's largest internationally active banks, in particular, regard the implementation (in Australia) of Basel II as critical. It will more closely align regulatory capital to their own economic capital models, facilitate their continued access to international capital markets and be an important element of their continuing presence in markets; and
- thirdly, APRA aims to ensure the regulatory approach in Australia is based on best practice.

APRA has determined that, in consultation with the industry, it is appropriate to align the Australian regulatory capital regime with Basel II.

### **Recommended option**

Option 2 (adoption of Basel II in Australia) is APRA's preferred option as it meets the objectives of a more risk-sensitive, internationally consistent, regulatory capital regime. Option 2 is also preferred by industry. The new regime will better safeguard Australian depositors by providing incentives for ADIs to improve their own internal risk management systems. The benefits outweigh the costs for ADIs as, amongst other things, regulatory capital requirements are better aligned with an institution's risk profile.

### **Implementation**

APRA intends to release the final prudential standards in advance of their effective date to assist industry in meeting the new requirements. Most of the draft prudential standards have been through a number of iterations and no substantive policy changes are now proposed for the final standards

It is proposed to release the final Basel II prudential standards in late November 2007 and all of these standards (with the exception of the prudential standard addressing IRRBB and Pillar 3 disclosure requirements) will become operative from 1 January 2008. The final reporting requirements will be released in advance of the April 2008 due date for submission of data and access to the electronic submission system, D2A, will also be provided in the first quarter of 2008.

Some transitional arrangements have been made available to ADIs seeking accreditation to adopt the advanced approaches. Those ADIs will be permitted to remain on the existing Accord for up to 12 months to allow them to focus on the remaining Basel II work, without the distraction of moving to the standardised approaches for a short period. (These ADIs will not receive capital relief associated with the implementation of Basel II during that period, except at the discretion of APRA.) In relation to reporting, ADIs will be able to request, where necessary, extensions to due dates for submission of data in accordance with existing APRA processes.

Once implemented, APRA will monitor the new requirements to ensure that they operate as intended, remain relevant to industry and continue to reflect international best practice. APRA has committed to review the interim arrangements (the transitional floor, margin lending and interim risk estimates) it has put in place in respect of the advanced approach to credit risk during 2008.

### Background

Basel II consists of three mutually reinforcing pillars. Pillar 1 sets out the mechanics of the revised minimum capital adequacy calculations and is the direct replacement for the existing Accord. Pillar 2 relates to the internal assessment of capital adequacy and the supervisory review process that should complement the 'black letter' Pillar 1 requirements. Pillar 3 sets out market disclosure standards aimed at strengthening the role of market discipline in supporting prudential objectives.

Pillar 1 provides the detailed requirements for assessing a bank's minimum capital adequacy position, consisting of the sum of internationally agreed mandatory capital components for credit risk, traded market risk and operational risk. A hierarchy of methods is available for each of these risk areas ranging from simple to more sophisticated calculation approaches, with the latter relying to varying degrees on an institution's internal risk measures.

The simplest approach for determining the credit risk capital component is the standardised approach, which uses external credit ratings for risk-weighting where available. This is the direct replacement for the existing prudential standard on credit risk. The two more sophisticated credit risk approaches are collectively referred to as internal ratings based (IRB) approaches. The foundation IRB (FIRB) approach permits a bank to use its own estimates of the probability of customer default (the probability of default), while the advanced IRB (AIRB) approach allows a bank additionally to use its own estimates of its exposure at the time the customer defaults (exposure at default) and the loss it will incur if the customer defaults (loss given default). Both IRB approaches take into account the maturities of a bank's credit exposures to corporate customers. The Framework does not provide a FIRB option for banks' retail exposures. The IRB approaches are new and there is no equivalent requirement under the existing Accord.

The traded market risk charge remains essentially unchanged from existing requirements. It is calculated using either a standardised or an approved internal models approach. This is the replacement for the market risk requirement under the Accord.

The Accord has no specific requirement for operational risk. Under Basel II, there are several relatively simple calculation methods available, including the basic indicator, standardised and alternative standardised approaches. The advanced measurement approach (AMA) is designed for banks with advanced operational risk management and modelling capabilities.

Pillar 2 is referred to as the 'supervisory review process' but it imposes obligations on both supervisors and banks. It requires banks to have a process and strategy for assessing and maintaining their overall capital adequacy in relation to their risk profile. In addition, banks are expected to operate above minimum regulatory capital levels to cover additional risks not covered explicitly by Pillar 1. Banks' strategies and capital assessments, as well as compliance with regulatory capital ratios, will be reviewed and evaluated by their supervisors. Where a supervisor judges that a bank is not holding sufficient capital to support its risk profile, the supervisor should

intervene to address this. APRA's existing supervision framework is largely consistent with Pillar 2, and will not be subject to a specific prudential standard.

Pillar 3 complements the other two pillars by encouraging market discipline through the development of a set of disclosure requirements that allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes and, ultimately, the capital adequacy of institutions.

### **National discretions**

The Basel II Framework sets minimum requirements, with national supervisors able to set higher requirements. In addition, some specific discretions are identified. APRA's approach to the exercise of discretions has taken account of the decision by all of Australia's internationally operating ADIs to seek to adopt the advanced approaches, either from the initial implementation of Basel II or shortly thereafter. That has allowed APRA some added flexibility in tailoring the standardised approaches, which will only be adopted by locally operating ADIs, to better meet market conditions and practices in Australia.

### **Standardised approaches**

For the standardised approaches, the more significant discretions exercised by APRA related to the risk weights for 'other retail' and residential mortgage loans (refer to the section on *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)* below) and the methodology for operational risk (refer to section on *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk (APS 114)* below).

#### *APS 112 Capital Adequacy: Standardised Approach to Credit Risk*

APS 112 sets out the simplest methodology available under Basel II for the credit risk component of the capital requirement. It requires that an ADI to risk-weight its on-balance sheet and off-balance sheet exposures for capital adequacy purposes and provides for recognition of certain collateral, credit risk mitigation and netting techniques. The new APS 112 replaces the existing *Prudential Standard APS 112 Capital Adequacy: Credit Risk*, with the key differences being:

- changes in the categories of claims used for risk-weighting purposes and increased granularity in the applicable risk-weights;
- an expanded range of eligible collateral and credit risk mitigation techniques;
- the introduction of a capital charge for short-term (less than one year) undrawn commitments;
- revised risk-weights for residential mortgage loans based on the characteristics of the loan (i.e. the loan-to-valuation ratio; whether a loan is covered by acceptable lenders mortgage insurance; and whether the ADI undertakes a full credit assessment of a borrower);
- differentiated treatment for past due or impaired residential mortgage loans

depending on whether or not the loans are covered by acceptable lenders mortgage insurance;

- the inclusion of the treatment of unsettled and failed transactions for capital adequacy purposes; and
- the introduction of an interim capital requirement for margin lending. A risk-weight of 20 per cent is to be applied to outstanding loans that are backed by listed equity investments; otherwise exposures are to be treated as secured loans. This treatment will be subject to further review by APRA.

In relation to the most significant national discretions, APRA does not propose to adopt the 75 per cent ‘other retail’ risk-weight proposed in the Basel II standardised approach to credit risk; these exposures would continue to be risk-weighted at 100 per cent. The proposed risk-weights under the standardised and internal ratings-based (IRB) approaches are meant to pertain to large, diversified portfolios. ADIs in Australia using the standardised approach, however, will generally not have a high degree of geographic or product diversification. Generally they will also have a higher average risk profile than the large, internationally operating banks considered by the Basel Committee when determining the risk weight for these exposures. In addition, APRA’s analysis indicates that for ADIs a 75 per cent risk-weight would offer an inadequate buffer for the other risks captured under the more sophisticated approaches but not under the standardised approach. At 100 per cent, the buffer would be no more than the 35 per cent risk-weight for eligible residential mortgage loans.

Through the use of increased granularity, the Basel II standardised approaches achieve greater risk sensitivity. With Australian ADIs typically holding large portfolios of residential mortgage loans, APRA believes it is appropriate to add increased granularity and therefore greater risk sensitivity to those portfolios. Accordingly, APRA proposes to introduce a risk-weighting scheme for residential mortgage loans which is based on the loan-to-valuation ratio (LVR) of a loan, the loan type (whether the loan is a standard or non-standard housing loan) and whether the loan has acceptable mortgage insurance covering a minimum of 40 per cent of the original loan amount. Depending upon these characteristics, a loan may be risk-weighted at 35, 50, 75 or 100 per cent, as detailed in Table 1. This compares to the current arrangements where, in order to qualify for a 50 per cent (concessional) risk-weight, a residential mortgage loan must have an LVR of less than 80 per cent (or 60 per cent for a non-standard loan) or be 100 per cent mortgage insured through an acceptable lenders mortgage insurer. APRA’s model is not only consistent with the Basel Committee’s intent to make the Basel II Framework more risk-sensitive, but also to apply the 35 per cent concessionary risk-weight in accordance with strict prudential criteria.



**Table 1****Risk-weights for residential mortgages**

LVR (%)	Standard eligible mortgages		Non-standard eligible mortgages	
	Risk-weight (no mortgage insurance) %	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI) %	Risk-weight (no mortgage insurance) %	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI) %
0 – 60	35	35	50	35
60.01 – 80	35	35	75	50
80.01 – 90	50	35	100	75
90.01 – 100	75	50	100	75
> 100.01	100	75	100	100

The new risk-weighting scheme places much greater emphasis on the relative riskiness of housing loans. For example, under the new scheme, a standard loan with an LVR of 90 to 100 per cent that is not mortgage insured will require an ADI to hold 50 per cent more capital than if the loan is in the 80 to 90 per cent LVR range. This is consistent with historical data which shows a strong significant relationship between LVR and the probability of default. By way of comparison, under the current arrangements, capital requirements for such loans do not change as the LVR increases above 80 per cent.

The proposed model also overcomes several limitations associated with the current treatment of non-standard loans. At present, there is no discrimination in capital requirements for non-standard loans where the LVR is above 60 per cent. That is, a non-standard loan with, for example, an LVR of 95 per cent has the same capital charge as a non-standard loan with a 65 per cent LVR. Clearly, the risk of the two loans is significantly different and capital requirements should reflect these differences. The proposed model addresses this deficiency. This is an important change, given the continual growth and development of non-standard loans and the fact that the performance of these loans can, at present, only be assessed in the favourable economic conditions that have prevailed in Australia in recent years.

An important feature of the proposal is that concessions associated with mortgage insurance cover require, at a minimum, the first 40 per cent of a loan to be insured by an acceptable lenders mortgage insurer. This ‘top-cover’ requirement is consistent with international practice and is based on evidence that 100 per cent mortgage insurance creates poor risk management incentives within ADIs. Although an ADI is in the best position to evaluate and monitor a loan, its incentive to do so is

considerably reduced when it perceives there is no risk of loss. This creates moral hazard problems and is the basis for a model of ‘top-cover’ as adopted in the United States and United Kingdom. The greater risk sensitivity of the capital requirements will reduce potential regulatory distortions.

To illustrate, had APRA simply reduced the concessional risk-weight from 50 per cent to the 35 per cent risk-weight proposed by the Basel Committee for eligible residential mortgage loans, a system with two risk-weights (35 and 100 per cent) would have resulted. Such a large difference in capital requirements around the 80 per cent LVR cut-off would have created incentives to circumvent the capital requirements, since the increase in regulatory capital above the 80 per cent LVR cut-off would have been disproportionately large, relative to the increase in economic risk. The proposed model significantly reduces such distortions by ensuring that increases in capital requirements around a particular LVR cut-off are much smaller (35 to 50 per cent; 50 to 75 per cent; and 75 to 100 per cent) than the jump from 35 to 100 per cent. APRA has assessed the capital impact of the new proposal and has determined that, relative to a system with just two risk-weights for housing loans of 35 and 100 per cent, the proposed model results in approximately the same level of overall capital requirements. The proposed model has the advantage of being more risk-sensitive and will therefore require relatively more capital for those institutions bearing greater risk. This is in line with the fundamental objectives of the Basel II reforms.

The table below summarises APRA’s approach to a number of discretions.

<i>Basel II Framework</i>	<i>APRA’s approach</i>
Apply a lower risk-weight to Australian dollar claims on the Commonwealth Government and the Reserve Bank of Australia where funded in Australian dollars	Yes
Recognise the lower risk-weights of other supervisory authorities for domestic currency sovereign exposures funded in that currency	No
Allow the recognition of export credit agencies’ country risk scores for risk weighting claims on sovereigns	No
Apply a lower risk-weight to claims guaranteed by the sovereign (or central bank) when denominated and funded in domestic currency	Yes — for the portion of Australian dollar exposures guaranteed by the Commonwealth Government and the Reserve Bank of Australia

<i>Basel II Framework</i>	<i>APRA's approach</i>
Claims on domestic public sector entities (PSEs) to be risk weighted using option one or option two for claims on ADIs	Claims on Australian and international local governments and non-commercial PSEs: option one (i.e. a risk-weight that is one category less favourable than that assigned to claims on the sovereign of that country) • Australian and international commercial PSEs: treated the same as claims against corporate counterparties
Claims on domestic PSEs may be treated as claims on the sovereign in the jurisdiction the PSE is established	Claims on Australian and international regional governments: to be treated the same as claims on the sovereign
Claims on ADIs may be risk-weighted one category less favourable than claims on the sovereign (option one) or based on the ADI's own external credit rating (option two)	Option two
Allow a preferential risk-weight for claims on ADIs with an original maturity of three months or less that are denominated and funded in the domestic currency	No — option two allows a preferential risk-weight that is one category more favourable for claims with an original maturity of three months or less, subject to a 20 per cent floor
Increase the standard risk-weight for unrated claims when a higher risk-weight is warranted by the default experience of the jurisdiction	No
Allow all corporate claims to be risk weighted at 100 per cent without regard to external ratings	Yes — requires APRA's approval in writing
Expand the definition of claims included in the regulatory retail portfolio	Not applicable
Set a numerical limit on the regulatory retail portfolio so that no aggregate exposure to a counterparty exceeds 0.2 per cent of the overall regulatory retail portfolio	Not applicable

<i>Basel II Framework</i>	<i>APRA's approach</i>
Increase risk-weights for regulatory retail exposures	Yes
Increase the preferential risk-weight (i.e. 35 per cent) for claims secured by residential properties	Yes
Allow certain commercial property loans to be risk-weighted at 50 per cent (subject to conditions)	No
Allow the risk-weight for the unsecured portion of a past due loan, net of specific provisions, to be reduced to 50 per cent when specific provisions are more than 50 per cent	No
Treat non-past due loans extended to counterparties subject to a 150 per cent risk-weight the same way as past due loans	No
Allow a transitional period of three years for the recognition of a wider range of collateral for higher risk (past due) loan	No
Allow a 100 per cent risk-weight for past due loans that are secured by other forms of collateral where provisions are greater than 15 per cent of the outstanding amount of the loan	No
Apply a risk-weight of 150 per cent or higher to other assets (e.g. venture capital and private equity investments)	Yes — a risk-weight of 300 per cent will be applied to listed equities and a risk-weight of 400 per cent to unlisted equities
Allow gold bullion held in ADIs' own vaults or on an allocated basis to the extent it is backed by bullion liabilities to be risk-weighted at zero per cent	Yes
Allow cash items in the process of collection to be risk-weighted at 20 per cent	Yes
Allow the use of a borrower's domestic currency rating for an exposure in foreign currency if the exposure is to a multilateral development bank	No

<i>Basel II Framework</i>	<i>APRA's approach</i>
Allow an ADI to use unsolicited ratings in the same way as solicited ratings	No
ADIs may calculate haircuts using their own internal estimates of market price volatility and foreign exchange volatility	Yes — requires APRA's approval in writing
Allow a zero haircut for certain types of repurchase and reverse repurchase agreements where the counterparty is a core market participant	Yes
Definition of core market participants	<p>Australian core market participants are:</p> <ul style="list-style-type: none"> <li>• Commonwealth Government and Reserve Bank of Australia</li> <li>• Governments and entities that qualify for zero per cent risk-weight</li> <li>• ADIs and overseas banks</li> <li>• Other financial companies</li> <li>• Recognised clearing organisations</li> </ul>
Recognise other supervisors' preferential treatment with regard to haircuts for repurchase and reverse repurchase agreements	No

*APS 114 Capital Adequacy: Standardised Approach to Operational Risk*

The Basel II Framework introduces a specific capital charge for operational risk. It provides three alternatives for the standardised approach to operational risk. Two of these, the basic indicator and standardised approaches, use gross income as the risk indicator and produce wide variations in outcomes among ADIs that cannot be tied readily to differences in operational risk. On the other hand, the third approach, the alternative standardised approach (ASA), which uses an asset indicator for ADIs' main business lines, results in an outcome that appears more consistent with the risk profile of the ADIs and will be the only standardised approach available to ADIs.

APRA is committed to keeping the regulatory capital requirement for smaller ADIs as simple as possible. The ASA proposals in the Basel II Framework require ADIs to map their activities into eight business lines. This classification of activities may be

difficult for some ADIs and may be an undue burden on ADIs' resources. In addition, an ADI's capacity to map its activities to business lines does not necessarily mean that the ADI has better operational risk management and, hence, less operational risk. Initially, APRA proposed the aggregation of activities into two areas of business which would have simplified the regulatory capital methodology without significantly dampening the sensitivity of the approach or materially increasing the regulatory capital charge. However, ADIs argued that the aggregation into three business lines would not significantly add to the complexity and would result in a more appropriate capital charge.

As a result, ADIs will aggregate each of their retail and commercial banking activities and separately aggregate all other activities into one other area of business. For the retail and commercial banking areas of business, a proportion of loans and advances is used as the proxy for the scale of business operations and thus the likely scale of operational risk exposure for that activity. Gross income is used as the proxy indicator for the all other activity area of business. Factors of 12, 15 and 18 per cent, respectively, have been proposed for the three aggregated areas of business. These factors serve as industry-wide estimates for the relationship between the operational risk loss experience for each area of activity and the proxy indicators (i.e. loans and advances or gross income, as appropriate).

Rather than aggregate net income for all other non-retail/commercial banking activities, ADIs will be able to use a base income figure from its regulatory reporting return and then 'strip out' material income and expense items that relate primarily to retail and commercial banking activities as the operational risk associated with those activities is captured in the retail and commercial banking areas of business and also to 'strip out' other income that does not generate material operational risk. Initially APRA proposed specifying those items that could be 'stripped out' but in the light of differences in the corporate structure of ADIs and how they structure their business, APRA will now provide guidance rather than prescription.

### **Advanced Approaches**

As previously noted, APRA has exercised considerably fewer national discretions under the advanced approaches. This largely, but not entirely, reflects the fact that the ADIs adopting these approaches operate in the global market place and Basel II seeks to ensure that such banks operate under similar supervisory regimes to the extent permitted by their home supervisors' legislative requirements and by local market practices.

#### *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*

APS 113 sets out the requirements for the FIRB and AIRB approaches to credit risk. Under APS 113, an ADI must be able to quantify certain credit risk components to determine the capital requirement for a given credit exposure and the ADI must have approval from APRA to use an IRB approach to credit risk for determining its capital requirement.

In relation to discretions under APS 113, APRA has exercised its discretion in respect of the four corporate sub-asset classes (project finance, object finance, commodities finance and income-producing real estate) known as specialised lending. ADIs that do

not meet the requirements for the estimation of probability of default for their specialised lending assets are required to map their internal risk grades to five supervisory categories, each of which is associated with a specific risk-weight. This version is termed the 'supervisory slotting approach'. APRA has required ADIs adopting the IRB approaches to use supervisory slotting to the full extent permitted by the Basel II Framework, pending further analysis of ADI processes and practices.

The Basel II Framework contains a number of thresholds expressed in Euros. Requiring that these thresholds be converted to Australian dollars at a current exchange rate would add considerable operational complexity to the Australian implementation. Moreover, the resulting Australian dollar levels would be excessive given Australian market practice. Accordingly, APRA is converting the Euro thresholds to Australian dollars on a (fixed) 1:1 basis.

Under the Basel II Framework, qualifying revolving retail (QRR) exposures are subject to a distinct IRB risk-weight function. Among the relevant classification criteria, QRR exposures must be to individuals. Business-related revolving facilities (for example, business overdraft facilities and credit cards where a business wholly or partially accepts responsibility for repayment) would not generally meet the qualifying criteria for QRR because they would not be exposures to individuals. An exception would be lending to an unincorporated sole trader. It is unclear, however, why the capital treatment for similar loans should differ simply because one is to a business organised as a sole trader and the other is to a business that has been incorporated. In order to provide a more consistent approach, APRA is restricting the QRR sub asset class to non-business exposures to individuals.

APRA has also added some clarification to the 'definition of default'. Basel II sets out several possible indicators that should be taken into account by an ADI when determining whether an obligor is unlikely to pay its credit obligations in full in a timely manner (that is, when an obligor should be considered in default and consequently for purposes of estimating probability of default (PD), loss given default (LGD) and exposure at default (EAD)). One of the criteria is if an ADI sells a credit obligation at a material credit-related economic loss. The requirement's purpose is to close a potential loophole whereby an ADI could avoid including certain exposures in its default database by selling them just prior to recording them internally as defaults. This could lead to a downwards bias in the institution's risk estimates. One difficulty with this requirement, however, is that unless an obligor is virtually certain of imminent default, any loss on sale experienced by the selling ADI will reflect a combination of PD and LGD considerations (that is, the recorded loss will only be a fraction of the likely underlying LGD). Unless PD and LGD can be untangled from one another, automatically including as defaults those obligations that have been sold at a credit-related economic loss could also lead to a downwards bias in an ADI's LGD estimates. In other words, in an attempt to resolve one problem, another (perhaps worse) problem is potentially created. Against this background, APRA will require an ADI adopting the IRB approach to have a policy requiring:

- the maintenance of an internal register of credit obligations sold at a material credit related economic loss;
- data contained in the register to be considered by the ADI in its rating system design and validation processes. The subsequent inclusion in, or exclusion

from, those processes of any data contained in the register must be justified and must not result in lower LGD estimates; and

- the creation and use of data in the register must be transparent to reviewers of the ADI’s rating systems, such as the ADI’s internal or external auditors and prudential regulators.

Under the Basel II Framework, a default is considered to have occurred if a material credit obligation is past due more than 90 days. For retail and public sector enterprises, national supervisors have discretion to substitute the 90-day threshold with one of up to 180 days. APRA will not exercise this discretion; however, for the purpose of calculating consolidated group-wide regulatory capital ADIs will be permitted to utilise host country definitions of default for the relevant exposures in their credit portfolios.

The Basel II Framework specifies that an ADI must calculate expected loss (EL) for its exposures and compare this amount to total eligible provisions. It provides for any excess of specific provisions over the EL amount on defaulted assets to be used to offset the EL amount on non-defaulted exposures. APRA has not permitted this treatment as specific provisions on defaulted exposures are raised on the basis of a full assessment of potential loss on individual exposures given current market conditions. APRA does not consider that it is prudentially sound to allow an excess of specific provisions on defaulted exposures (calculated based on assessment of individual exposures) over the EL amount on defaulted exposures (calculated using long-term general estimates) to be included in the capital base of the ADI.

APRA has maintained the treatment that allows the excess of eligible provisions over EL for non-defaulted exposures to be eligible for inclusion in an ADI’s Tier 2 capital up to a maximum of 0.6 per cent of credit risk-weighted assets.

The table below summarises APRA’s approach to a number of other discretions.

<i>Basel II Framework</i>	<i>APRA’s approach</i>
Relaxation of minimum requirements for data and use of rating systems	No
For specialised lending exposures, allow banks to assign preferential risk weights for unexpected loss of 50 per cent to ‘strong’ exposures and 70 per cent to ‘good’ exposures provided they have a remaining maturity of less than 2.5 years or the supervisor determines that banks’ underwriting and other risk characteristics are substantially stronger than specified in the slotting criteria for the relevant supervisory category	No



**Basel II Framework****APRA's approach**

For high volatility commercial real estate exposures, allow banks to assign preferential risk weights of 70 per cent to 'strong' exposures and 95 per cent to 'good' exposures provided they have a remaining maturity of less than 2.5 years or the supervisor determines that banks' underwriting and other risk characteristics are substantially stronger than specified in the slotting criteria for the relevant supervisory risk category

Not applicable (APRA does not propose to have a HVCRE specialised lending sub-asset class)

*APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk*

The main variation from the Basel II Framework being implemented by APRA is the requirement that ADIs adopting the IRB approaches for credit risk must also adopt the advanced measurement approaches (AMA) for operational risk. The intent is that where an ADI is a 'modelling' ADI, it should model all its risks. This ensures that, amongst other things, an ADI is not able to 'cherry-pick' its capital requirements. In addition to this change, APRA has added some explanation and guidance.

The AMA does not require that an ADI's operational risk measurement system be based on any particular measurement technique but does require that an ADI meet the following:

- the ADI must have in place systematic and transparent operational risk management and measurement practices that are able to be independently reviewed and validated;
- the ADI must have in place a framework to manage, measure and monitor operational risk that is commensurate with the nature, scale and complexity of the ADI's operations;
- the ADI must collect operational risk loss data;
- the ADI must map its operational risk regulatory capital (ORRC) to the business lines detailed in the prudential standard or its own business lines (which in turn must be mapped to those in the prudential standard);
- the ADI's operational risk measurement system must take into account internal and relevant external data, scenario analysis and specific indicators of the ADI's current and planned future operational risk profile and factors related to the assessment of the ADI's internal control framework;
- the ORRC, as determined by the ADI's own operational risk measurement system, must cover unexpected and expected operational risk losses unless the ADI can demonstrate to APRA that it has adequately measured and accounted

for expected losses in its business practices by way of offsets as detailed in the prudential standard;

- the ORRC must be comparable to a 99.9 per cent confidence level and a one-year holding period;
- subject to meeting certain criteria, an ADI may recognise the risk-mitigating effect of appropriate insurance in determining its ORRC up to a limit of 20 per cent of the total ORRC;
- the ADI may use internal estimates of dependence among operational risk losses across operational risk classes if it can demonstrate that its systems for estimating dependence are sound, robust under a variety of scenarios, implemented with integrity and appropriately take into account the level of uncertainty surrounding the estimates. Where an ADI has received written approval from APRA, it may incorporate its dependence assumptions into its calculation ORRC; and
- significant locally incorporated subsidiaries of foreign ADIs must calculate ORRC using a stand-alone operational risk measurement model that complies with the requirements of APS 115 with the exception that while the ADI may incorporate diversification benefits from its own operations (including those arising from its own subsidiaries), it may not incorporate group-wide diversification benefits.

*APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*

The Basel II Framework states that interest rate risk in the banking book (also described as ‘non-traded interest rate risk’) is potentially a significant risk which merits support from capital. Basel II also states that where supervisors consider that there is sufficient homogeneity within the banking industry regarding the nature and methods for monitoring and measuring this risk, a mandatory minimum capital requirement could be established.

APRA is requiring ADIs that use the IRB approach to credit risk and an AMA to operational risk to hold specific regulatory capital against non-traded interest rate risk. In the case of ADIs using the standardised approaches, APRA will monitor each ADI’s exposure to non-traded interest rate risk and will, as at present, take this assessment into account when determining the overall regulatory capital requirement. In particular, ADIs that are identified from the returns as ‘outliers’ will be expected to maintain a minimum capital ratio that reflects their non-traded interest rate risk.

APRA’s approach to IRRBB is consistent with the Basel Committee on Banking Supervision’s July 2004 document *Principles for the Management and Supervision of Interest Rate Risk*.

There is a trade-off between holding periods and confidence intervals used in value-at-risk (**VaR**) assessments; longer holding periods and higher confidence levels usually generate higher capital requirements and shorter holding periods and lower confidence levels usually generate lower requirements. In particular, a longer holding period (compared with traded market risk) is considered appropriate for the regulatory

capital for non-traded interest rate risk given the longer-term nature of the instruments involved.

APRA's IRRBB requirements are that:

- an ADI must hold regulatory capital against non-traded interest rate risk and have in place appropriate risk management practices;
- an ADI must have in place a framework to measure, manage and monitor non-traded interest rate risk that is commensurate with the nature, scale and complexity of the ADI's operations;
- an ADI must seek approval from APRA to use an internal non-traded interest rate risk measurement model for determining the regulatory capital for non-traded interest rate risk;
- for the purpose of APRA's proposed prudential framework, non-traded interest rate risk has four components: repricing risk, yield curve risk, optionality risk and basis risk, all of which must be covered by the ADI's model; and
- the regulatory capital for non-traded interest rate risk must be based on a 99 per cent confidence level and one-year holding period.

### **Prudential standards common to the standardised and advanced approaches**

#### *APS 120 Securitisation*

APS 120 sets out the requirements for the standardised and IRB approaches to determining the credit risk capital charges for securitisation activities. It outlines the criteria that need to be met for an ADI to exclude assets it has originated into (or sold to) a special purpose vehicle (SPV), from its risk-weighted assets, for the purposes of APS 112 or APS 113. In addition, it sets out the capital requirements that arise from facilities and services provided to and other dealings with securitisation SPVs.

Unlike many regulators, APRA has longstanding prudential requirements reflected in the existing *APS 120 Funds Management and Securitisation* which govern ADIs' securitisation activities. Relative to the Framework, this standard provides additional guidance on:

- disclosure by an SPV to investors;
- separation of an SPV from an ADI; and
- the provision of facilities and services to, and treasury dealings with, SPVs.

The existing requirements are, however, more permissive in certain areas particularly in regard to the treatment of asset-backed commercial paper (ABCP) securitisation.

While APRA adopted virtually unchanged the new capital calculation methodologies in the Framework, it also retained and upgraded a number of the existing requirements that have historically been applied to ADIs. These additional requirements have,

however, been simplified and made more principles-based. In addition, as requested by industry, APRA will move away from the current pre-approval of securitisation transactions and permit ADIs to undertake self-assessment of compliance with the prudential standard. Provisions have been included in the standard to facilitate the transition to this new approach.

APRA's requirements have also been modified from those in the Framework to cater for specific features of the local securitisation market, which is well developed in comparison to markets in many other countries. Examples of tailoring for local market conditions include:

- the accommodation of warehouse facilities;
- the recognition of issues raised by securitising redrawable home loans, e.g. sharing of collateral between the ADI and SPV, repurchasing exposures and an exemption from the requirement to treat them as a revolving credit securitisation;
- the special recognition of basis swaps; and
- specific accommodation of the market practice, where an ADI is not suitably rated, of providing cash collateral to support facilities provided by an ADI to a SPV;

APRA also has departed from the Framework in several areas where its strict application was seen as being excessively complex or penal. These include:

- simplifying the provisions by which a cap is placed against the amount of capital an originating ADI can be required to hold against a specific securitisation scheme;
- adopting a more proportionate penalty regime for when an ADI provides implicit support to an SPV or otherwise breaches the standard; and
- for IRB banks, extending the internal assessment approach (IAA) to all securitisation schemes rather than restricting it to ABCP schemes.

The table below summarises APRA's approach to the national discretions relevant to the securitisation requirements in the Framework. APRA understands that in light of the recent issues with the sub-prime debt markets, few supervisors are likely to exercise the national discretion with regard to market disruption liquidity facilities.

<i>Basel II Framework</i>	<i>APRA's approach</i>
Apply a zero per cent credit conversion factor (CCF) for eligible liquidity facilities that are only available in the event of market disruption.	No

**Basel II Framework****APRA's approach**

Under the internal ratings-based approach to securitisation, where an ADI is unable to calculate  $K_{IRB}$  using the bottom-up or top-down approach for a liquidity facility, ADI's may use an alternative treatment on an exceptional and temporary basis.

Yes, has been extended so that it can apply to all eligible facilities

Allow undrawn servicer cash advances that are unconditionally cancellable without prior notice to be eligible for a zero per cent CCF.

Yes

*APS 116 Market Risk*

The requirements set out in *Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116)* are consistent with the Basel II Framework.<sup>2</sup> The key requirements are as follows:

- an ADI must allocate positions in financial instruments to its trading book if they are held with trading intent or in order to hedge other elements of the trading book;
- an ADI must maintain a framework for prudent valuation practices for trading book positions;
- an ADI operating in the foreign exchange, commodities, interest rate or equities markets must have appropriately robust risk measurement and management systems in place;
- an ADI must hold capital against market risks arising from positions allocated to the trading book and all foreign exchange and commodity risks (TFC capital requirement); and
- an ADI must calculate the TFC capital requirement using one of the following methods:
  - the standard method;
  - the internal model approach; or

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<sup>2</sup> The November 2005 version of the Basel II Framework incorporates the elements of the Market Risk Amendment (which was originally released in 1996 to add capital requirements for market risk to the current Accord) that were not revised during the Basel II process and the requirements of the July 2005 paper *The application of Basel II to trading activities and the treatment of double default effects*.

- a combination of these two methods.

The differences between APS 116 and the current prudential standard (APS 113 Capital Adequacy: Market Risk) are mainly a reflection of the changes under the Basel II Framework. The key changes are:

- more granular specific risk capital charges, based on external credit assessments, under the standard method;
- the use of a non-zero risk-weighting for lower-rated government securities, and an increase in the maximum charge for lower-rated securities from eight per cent to 12 per cent under the standard method; and
- the inclusion of incremental default risk charge, where the VaR measure includes an estimation of the specific risk charge under the internal model approach.

In addition, in cases where the requirements of the current prudential standard had previously diverged from the Accord, changes have been made so that APS 116 is now more closely aligned to the Basel II Framework. The key changes are:

- the removal of the use of internal limits to measure market risk capital; and
- the removal of a limitation of five on the multiplication factor under the internal model approach.

The Framework allows national supervisors the discretion to require ADIs to perform back testing on either hypothetical outcomes (i.e. using changes in portfolio value that would occur were end-of-day positions to remain unchanged) or actual trading outcomes (i.e. excluding fees, commissions and net interest income), or both. APRA has exercised this discretion and accordingly APS 116 requires an ADI to perform back tests using both hypothetical and actual trading outcomes.

### **Pillar 1 reporting requirements**

In conjunction with the introduction of Pillar 1 prudential requirements, APRA is implementing reporting requirements comprising a combination of amendments to existing requirements and some new requirements. The adoption of new capital adequacy standards has necessitated that the reporting requirements be revised and these changes reflected in a set of new reporting forms (Basel II forms).

Under the existing capital adequacy regime, all ADIs are required to report on the following capital adequacy reporting forms:

- Reporting Form ARF 110.0 Capital Adequacy;
- Reporting Form ARF 112.1 Capital Adequacy - On-Balance Sheet Business Risk-Weighting Schedule;
- Reporting Form ARF 112.2 Capital Adequacy - Off-Balance Sheet Business;

and

- Reporting Form ARF 113.0 Market Risk.

Consistent with the existing regime, the existing reporting forms only address credit risk and market risk. Under the Basel II Framework, there is a broader coverage of risks and this is reflected in the Basel II suite of reporting forms. The new suite includes forms for collecting data on operational risk, securitisation and interest rate risk in the banking book.

Under Basel II, an ADI's reporting requirements will be determined by the approaches (standardised or advanced) that it adopts for each category of risk. ADIs adopting the advanced approaches will be required to report significantly more detailed data than ADIs adopting the standardised approaches.

Standardised ADIs will be required to report on amended versions of the four existing capital adequacy forms, which under Basel II will become the forms for the standardised approaches. Amendments to those forms reflect the requirements of the new Basel II capital adequacy standards (for example, the new form ARF 112.1 Standardised credit risk – on-balance sheet business includes a more granular breakdown of risk-weighting for claims). Standardised ADIs will also be required to provide information on those risks for which under the existing Accord there were no specific capital charges, including operational risk and securitisation.

For advanced ADIs, each risk category has new reporting requirements. For credit risk, advanced ADIs will be required to provide summary level data (where relevant) on credit risk components (PD, LGD, EAD and maturity) for the IRB asset classes and details on the risk-weighting of securitisation transactions. For operational risk, advanced ADIs will be required to provide a breakdown of the components of AMA regulatory capital and map regulatory capital to the Basel business lines and event types. In addition, they will be required to provide operational risk loss data.

For market risk, advanced ADIs will be required to complete an amended version of the existing market risk form and a new form on interest rate risk in the banking book. Where an advanced ADI has APRA approval to use the standardised approach for a business unit or a portfolio, the ADI will also be required to complete the relevant standardised form in relation to that portion of their business.

All ADIs will be required to report on amended versions of the existing form ARF 113.1 Repricing Analysis (currently, only applicable to credit unions and building societies) and on a new form collecting supplementary prudential information on securitisation, ARF 120.2 Securitisation – Supplementary Items.

As a natural consequence of the increased risk-sensitivity of the Basel II Framework, when compared with the existing capital adequacy forms, the Basel II forms generally require more detailed reporting.

## **Pillar 2**

Pillar 2 of the Basel II Framework is intended to ensure that ADIs have adequate capital to support all the risks in their business and to encourage ADIs to develop and

use better risk management techniques in monitoring and managing their risks.

APRA's approach to Pillar 2 is not prescriptive – APRA will not be issuing prudential standards – and follows closely the approach of the Basel II Framework. APRA also notes that its existing supervision framework is largely consistent with the Pillar 2 requirements. As described in the Basel II Framework, it will adopt a proportional approach to Pillar 2 consistent with the nature, scope and complexity of its activities.

For those ADIs that adopt the advanced approaches, there are transitional arrangements to allow supervisors to gain comfort with the robustness of the risk estimates and their use. The arrangements limit the extent to which capital levels are allowed to fall relative to what would have applied had the Basel II Framework not been adopted. The maximum reduction in capital is 10 per cent until the end of 2008 and retained during 2009 pending a review of experience with the advanced Basel II approaches.

### **Pillar 3**

Pillar 3 of the Basel II Framework is intended to complement the other two Pillars by encouraging market discipline through disclosure that will enable market participants to assess the capital adequacy of ADIs.

APRA has taken a pragmatic approach to the introduction of Pillar 3 disclosure requirements for ADIs, based on those outlined in the Framework. In particular, it has looked to minimise the reporting burden on the smaller ADIs, while seeking to meet both the market's demand for prudential information and APRA's responsibilities as a supervisor of internationally active banks.

APRA has introduced a new prudential standard, *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information (APS 330)*, setting out minimum prudential disclosure requirements for locally incorporated ADIs. The standard recognises that to be useful to a range of market participants, such disclosures should reflect the degree of sophistication applied by an ADI in managing risk, which in turn should reflect the scope and complexity of the ADI's operations. At the same time, an ADI should seek to ensure that all market participants can readily access some basic prudential information on the ADI's capital adequacy on a regular basis.

The requirements in APS 330 have therefore been tailored to the two broad approaches that will be taken by ADIs in measuring their capital adequacy for regulatory purposes. The key requirements of the standard are:

- locally incorporated ADIs that are Australian-owned and have approval from APRA to use the advanced approaches are required to disclose a range of both quantitative prudential information (on a semi-annual basis) and qualitative prudential information (on an annual basis), in addition to the disclosure of some basic prudential information (on a quarterly basis);
- locally incorporated ADIs that are Australian-owned and use the standardised approaches are required to disclose a basic set of information (on a quarterly



basis); and

- locally incorporated ADIs that are foreign-owned are required to disclose a basic set of prudential information (on a quarterly basis), although APRA may, on a case-by-case basis, require these institutions to make more frequent or extensive disclosures.

This latter requirement is consistent with the Basel II Framework and is based on the premise that the overseas parent will be making regular detailed disclosures of the group's capital adequacy. However, the Framework also gives discretion to host supervisors to set separate disclosure requirements on local banking subsidiaries, and APRA sees value in those ADIs disclosing the same set of basic quantitative prudential information as Australian-owned ADIs on a quarterly basis. As foreign-owned subsidiaries raise deposits in Australia, this disclosure is consistent with APRA's 'depositor protection' responsibilities. It will add little to costs because the ADIs are already generating the information as part of their normal prudential reporting to APRA.

More generally, and again consistent with the Framework, APRA can vary disclosure requirements that apply to an individual ADI having regard to its particular circumstances.