

Banking (prudential standard) determinations Nos. 2 to 17 of 2012

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 29 November APRA made the following determinations (the instruments):

- (1) Banking (prudential standard) determination No. 2 of 2012 (the instrument), which determines a new *Prudential Standard APS 001 Definitions* (APS 001);
- (2) Banking (prudential standard) determination No. 3 of 2012 (the instrument), which revokes *Prudential Standard APS 110 Capital Adequacy* made under Banking (prudential standard) determination No. 3 of 2007, and determines a new *Prudential Standard APS 110 Capital Adequacy* (APS 110);
- (3) Banking (prudential standard) determination No. 4 of 2012 (the instrument), which revokes *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* made under Banking (prudential standard) determination No. 5 of 2011, and determines a new *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111);
- (4) Banking (prudential standard) determination No. 5 of 2012 (the instrument), which revokes *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* made under Banking (prudential standard) determination No. 1 of 2010, and determines a new *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112);
- (5) Banking (prudential standard) determination No. 6 of 2012 (the instrument), which revokes *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* made under Banking (prudential standard) determination No. 6 of 2007, and determines a new *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113);
- (6) Banking (prudential standard) determination No. 7 of 2012 (the instrument), which revokes *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk* made under Banking (prudential standard) determination No. 7 of 2007, and determines a new *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk* (APS 114);

- (7) Banking (prudential standard) determination No. 8 of 2012 (the instrument), which revokes *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* made under Banking (prudential standard) determination No. 8 of 2007, and determines a new *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* (APS 115);
- (8) Banking (prudential standard) determination No. 9 of 2012 (the instrument), which revokes *Prudential Standard APS 116 Capital Adequacy: Market Risk* made under Banking (prudential standard) determination No. 6 of 2011, and determines a new *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116);
- (9) Banking (prudential standard) determination No. 10 of 2012 (the instrument), which revokes *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* made under Banking (prudential standard) determination No. 10 of 2007, and determines a new *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* (APS 117);
- (10) Banking (prudential standard) determination No. 11 of 2012 (the instrument), which revokes *Prudential Standard APS 120 Securitisation* made under Banking (prudential standard) determination No. 7 of 2011, and determines a new *Prudential Standard APS 120 Securitisation* (APS 120);
- (11) Banking (prudential standard) determination No. 12 of 2012 (the instrument), which revokes *Prudential Standard APS 220 Credit Quality* made under Banking (prudential standard) determination No. 14 of 2007, and determines a new *Prudential Standard APS 220 Credit Quality* (APS 220);
- (12) Banking (prudential standard) determination No. 13 of 2012 (the instrument), which revokes *Prudential Standard APS 221 Large Exposures* made under Banking (prudential standard) determination No. 15 of 2007, and determines a new *Prudential Standard APS 221 Large Exposures* (APS 221);
- (13) Banking (prudential standard) determination No. 14 of 2012 (the instrument), which revokes *Prudential Standard APS 222 Associations with Related Entities* made under Banking (prudential standard) determination No. 3 of 2008, and determines a new *Prudential Standard APS 222 Associations with Related Entities* (APS 222);
- (14) Banking (prudential standard) determination No. 15 of 2012 (the instrument), which revokes *Prudential Standard APS 310 Audit and Related Matters* made under Banking (prudential standard) determination No. 8 of 2011, and determines a new *Prudential Standard APS 310 Audit and Related Matters* (APS 310);
- (15) Banking (prudential standard) determination No. 16 of 2012 (the instrument), which revokes *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* made under

Banking (prudential standard) determination No. 9 of 2011, and determines a new *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (APS 330); and

- (16) Banking (prudential standard) determination No. 17 of 2012 (the instrument), which revokes *Prudential Standard APS 610 Prudential Requirements for Providers of Purchased Payment Facilities* made under Banking (prudential standard) determination No. 18 of 2007, and determines a new *Prudential Standard APS 610 Prudential Requirements for Providers of Purchased Payment Facilities* (APS 610).

The instruments commence on 1 January 2013.

1. Background

A key component of APRA's prudential framework is the suite of prudential standards that impose regulatory capital requirements on ADIs (the capital standards) for the purpose of ensuring ADIs hold sufficient capital to address the risks associated with their operations. The capital standards have their foundation in international capital standards set down by the Basel Committee of the Bank for International Settlements in the 1998 Basel Capital Accord (Basel I), the *International Convergence of Capital Measurement and Capital Standards* (Basel II) released in 2004 and enhancements to Basel II introduced during the global financial crisis. The latest alterations to the prudential standards made under the instruments are intended to build on this foundation by implementing changes, consistent with those set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III) announced in response to the global financial crisis. These changes are designed to further strengthen the capital position of ADIs by addressing deficiencies identified during the global financial crisis.

The global financial crisis also affected international securitisation markets. Authorised deposit-taking institutions use securitisation to bundle together (securitise) pools of assets and transfer them to a third party to be used as collateral for securities sold to investors. These securities are usually split into tranches of varying degrees of subordination with different levels of risk exposure. During the crisis, investors were reluctant to buy the more risky tranches, which were left with ADIs. This had an impact on the amount of regulatory capital these ADIs were required to hold.

2. Purpose and operation of the instruments

Banking (prudential standard) determination No. 2 of 2012

The purpose of this instrument is to make the new APS 001.

APS 001 is a new prudential standard that seeks to incorporate common definitions used in ADI prudential standards into a single prudential standard. Generally, only definitions that are unique to a particular prudential standard will be retained in that prudential standard; otherwise, definitions common to two or more prudential standards have been consolidated in APS 001.

Banking (prudential standard) determination No. 3 of 2012

The purpose of the instrument is to revoke APS 110 and to replace it with a new version of APS 110.

APS 110 aims to ensure that ADIs hold adequate capital on both an individual and group basis to act as a buffer against the risks associated with their activities. This instrument changes APS 110 in order to strengthen this capital buffer. The key changes to APS 110 are:

- revised ‘Internal Capital Adequacy Assessment Process’ requirements to reflect international good practice and to align with those intended to be introduced for life companies and general insurers. These new requirements include stress testing and scenario analysis of potential risk exposures and capital requirements, new Board reporting requirements and the need for policies to address the capital impact of material risks not covered by explicit regulatory capital requirements;
- revised minimum capital adequacy requirements, consistent with Basel III. These are reflected in the revised Prudential Capital Requirements, expressed as a percentage of risk-weighted assets, and include the need for an ADI to hold a minimum Common Equity Tier 1 Capital ratio of 4.5 per cent, a minimum Tier 1 Capital ratio of 6 per cent and a minimum Total Capital ratio of 8 per cent;
- the introduction of a capital conservation buffer above the Prudential Capital Requirement of 2.5 per cent of an ADI’s total risk-weighted assets, unless otherwise determined, in writing, by APRA;
- the introduction of a new countercyclical capital buffer whereby an ADI must, if APRA so requires, hold additional Common Equity Tier 1 Capital of between zero and 2.5 per cent of total risk-weighted assets in the form of a countercyclical capital buffer; and
- the introduction of new constraints on capital distributions when an ADI’s Common Equity Tier 1 Capital ratio falls within a defined ‘capital buffer’ range.

Banking (prudential standard) determination No. 4 of 2012

The purpose of the instrument is to revoke APS 111 and to replace it with a new version of APS 111.

APS 111 sets out details of the characteristics of instruments required in order to be considered eligible for inclusion as part of an ADI’s regulatory capital. APS 111 also sets out deductions to regulatory capital in order to arrive at a measure of total regulatory capital on a Level 1 and Level 2 basis.

This instrument makes changes to APS 111 consistent with the Basel III capital framework, including:

- revised deduction requirements;

- certain deductions that were previously deducted on a 50/50 basis from Tier 1 and Tier 2 capital are now risk-weighted at 1250 per cent;
- certain deductions that were previously deducted on a 50/50 basis from Tier 1 and Tier 2 capital are now deducted from Common Equity Tier 1 Capital; and
- certain deductions that were previously deducted from Tier 1 Capital are now deducted from Common Equity Tier 1 Capital.

Banking (prudential standard) determination No. 5 of 2012 and Banking (prudential standard) determination No. 6 of 2012

The purpose of the instruments is to revoke APS 112 and APS 113 and to replace them with new versions of APS 112 and APS 113 respectively.

APS 112 and APS 113 require ADIs to hold sufficient regulatory capital against credit risk exposures. APS 112 applies to an ADI using the standardised approach to credit risk and APS 113 applies to an ADI with approval to use the internal ratings-based approach to credit risk.

The instruments make changes to APS 112 and APS 113 commensurate with the Basel III framework by imposing new capital requirements for counterparty credit risk, including for bilateral trades and certain exposures to central counterparties.

Commensurate with the Basel III framework, other changes to APS 112 include:

- imposing new risk-weights to specified items;
- requiring deduction from Common Equity Tier 1 Capital instead of from Tier 1 Capital for specified items;
- relaxing the regulatory treatment of certain letters of credit used in trade financing; and
- incorporating credit mapping guides currently contained in a prudential practice guide.

Commensurate with the Basel III framework, other changes to APS 113 include requiring certain deductions to be made from Common Equity Tier 1 Capital.

Each instrument also makes minor alterations to APS 112 and 113 to align with Basel III terminology, address existing anomalies and to update references to other prudential standards and regulatory requirements.

Banking (prudential standard) determination No. 7 of 2012 and Banking (prudential standard) determination No. 8 of 2012

The purpose of the instruments is to revoke APS 114 and APS 115 and to replace them with new versions of APS 114 and APS 115 respectively.

APS 114 and APS 115 require ADIs to hold sufficient regulatory capital against their operational risk exposures. APS 114 applies to an ADI using the standardised approach to operational risk and APS 115 applies to an ADI with approval to use an advanced measurement approach to operational risk.

The instruments make minor alterations to APS 114 and APS 115, respectively, to align with Basel III terminology and to update references to other prudential standards.

Banking (prudential standard) determination No. 9 of 2012

The purpose of the instrument is to revoke APS 116 and to replace it with a new version of APS 116.

APS 116 requires an authorised deposit-taking institution engaging in activities that give rise to risks associated with potential movements in market prices to adopt risk management practices and hold regulatory capital commensurate with the risks involved.

The instrument makes changes to APS 116 commensurate with the Basel III framework, including applying specific capital charges on certain securitisations and other exposures previously subject to deduction. The instrument also makes minor alterations to align with Basel III terminology and to update references to other prudential standards.

Banking (prudential standard) determination No. 10 of 2012

The purpose of the instrument is to revoke APS 117 and to replace it with a new version of APS 117.

APS 117 sets out the requirements that an ADI with approval to use an internal model for interest rate risk in the banking book must meet for regulatory capital purposes, both at the time of initial implementation and on an ongoing basis.

The instrument changes APS 117 commensurate with the Basel III framework by including items in Common Equity Tier 1 Capital instead of Fundamental Tier 1 Capital in the definition of 'banking book items'. The instrument makes minor alterations to align with Basel III terminology and to update references to other prudential standards.

Banking (prudential standard) determination No. 11 of 2012

The purpose of the instrument is to revoke APS 120 and to replace it with a new version of APS 120.

APS 120 requires ADIs to adopt prudent practices in managing the risks associated with securitisation and to ensure that sufficient regulatory capital is held against the associated credit risk.

The instrument makes changes to APS 120 commensurate with the Basel III framework, including:

- deducting certain items from Common Equity Tier 1 Capital instead of from Tier 1 capital;
- risk-weighting certain securitisation exposures at 1250 per cent instead of deducting them on a 50/50 basis from Tier 1 and Tier 2 Capital under the existing APS 120; and
- deleting certain obsolete provisions.

The instrument also alters APS 120 to clarify the treatment for regulatory capital purposes of subordinated tranches held by ADIs as a result of disruption to the securitisation market caused by the global financial crisis. Such holdings are to be deducted from Common Equity Tier 1 Capital except in certain circumstances.

The instrument makes minor alterations to APS 120 to align with Basel III terminology and to update references to other prudential standards.

Banking (prudential standard) determination No. 12 of 2012

The purpose of the instrument is to revoke APS 220 and to replace it with a new version of APS 220.

APS 220 requires an ADI to control credit risk by adopting prudent credit risk management policies and procedures for the recognition, measurement and reporting of, and provisioning for, impaired facilities.

The instrument changes APS 220 commensurate with the Basel III framework to deduct from Common Equity Tier 1 Capital specified provisions, amounts in the General Reserve for Credit Losses, restructured facilities and other items previously deducted from Tier 1 Capital. The instrument also incorporates into APS 220 previously separate *Guidance Notes AGN 220.1 Impaired Facility Definitions* (AGN 220.1), *AGN 220.2 Impairment, Provisioning and the General Reserve for Credit Losses* (AGN 220.2), *AGN 220.3 Prescribed Provisioning* (AGN 220.3) and *AGN 220.4 Credit Risk Grading Systems* (AGN 220.4), which formed part of the revoked version of APS 220. The instrument also makes minor alterations to APS 220 to align with Basel III terminology and to update references to other prudential standards.

Banking (prudential standard) determination No. 13 of 2012

The purpose of the instrument is to revoke APS 221 and to replace it with a new version of APS 221.

APS 221 requires ADIs to implement prudent measures and to set prudent limits to monitor and control their large exposures, on both a Level 1 and Level 2 basis.

The instrument makes minor alterations to APS 221 to align with Basel III terminology and to update references to other prudential standards.

Banking (prudential standard) determination No. 14 of 2012

The purpose of the instrument is to revoke APS 222 and to replace it with a new version of APS 222.

APS 222 sets out prudential requirements for ADIs in their dealings with related entities, and notably requires that they give due consideration to the risks associated with the corporate group of which they are a member and that they are not exposed to excessive risk as a result of their dealings with related entities. The purpose of the instrument is to insert a new provision that provides APRA with discretion to vary the large exposure limits that apply to an ADI's exposures to counterparties, groups of counterparties, industry sectors etc, should APRA consider there are prudential grounds for doing so. This provision aligns APRA's discretionary powers under APS 221 and APS 222.

In addition, the instrument incorporates requirements for Extended Licensed Entities (ELEs) that were previously included in APS 110.

Banking (prudential standard) determination No. 15 of 2012

The purpose of the instrument is to revoke APS 310 and to replace it with a new version of APS 310.

APS 310 requires an ADI to ensure that APRA has access to independent advice from an auditor relating to the operations, internal controls and information provided to APRA in respect of that ADI. APS 310 also sets out requirements for the roles and responsibilities of the appointed auditor.

The instrument makes minor alterations to APS 310 to align with Basel III terminology and to update cross-references to other prudential standards.

Banking (prudential standard) determination No. 16 of 2012

The purpose of the instrument is to revoke APS 330 and to replace it with a new version of APS 330.

APS 330 requires locally incorporated ADIs to meet minimum requirements for the public disclosure of information on their risk management practices and capital adequacy to enhance transparency in Australian financial markets.

The instrument makes minor alterations to APS 330 to align with Basel III terminology and to update cross-references to other prudential standards.

Banking (prudential standard) determination No. 17 of 2012

The purpose of the instrument is to revoke APS 610 and to replace it with a new version of APS 610.

APS 610 requires an ADI that has an authority to provide purchased payment facilities to meet prudential requirements commensurate with its risk profile.

The instrument makes minor alterations to APS 610 to align with Basel III terminology and to update references to other prudential standards.

3. Consultation

APRA undertook extensive consultation on the proposed implementation of the Basel III capital reforms over the course of 2011 and 2012. This has involved formal consultation with industry as well as meetings with parties affected by the proposals and speeches in various forums by senior APRA staff. Consultation packages have included:

1. Discussion paper, *Implementing Basel III Capital Reforms in Australia* (September 2011);
2. Response paper, *Implementing Basel III Capital Reforms in Australia* (March 2012);
3. Discussion paper, *Basel III capital reforms reporting requirements* (June 2012);
4. Letter to industry, *Basel III Capital - Governing law and joint arrangements* (June 2012);
5. Discussion paper, *Basel III capital: counterparty credit risk and other measures* (August 2012);
6. Response paper: *Implementing Basel III capital reforms in Australia* (September 2012); and
7. Response paper, *Implementing Basel III capital reforms in Australia - counterparty credit risk and other measures* (November 2012).

The attached Regulation Impact Statement discusses in detail the consultation undertaken by APRA in relation to the Basel III capital reforms, including APRA's response to the key issues raised during the course of the consultation process.

4. Regulation Impact Statement

APRA prepared a Regulation Impact Statement, which is attached.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

The instruments do not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights*

(Parliamentary Scrutiny) Act 2011. Accordingly, in APRA's assessment, the instruments are compatible with human rights.



Regulation Impact Statement

Implementing Basel III capital reforms in Australia

(OBPR ID: 2012/13813)

This Regulation Impact Statement (RIS) addresses the Australian Prudential Regulation Authority's (APRA's) proposed changes to prudential and reporting standards applying to authorised deposit-taking institutions (ADIs). These changes would implement the capital adequacy requirements known as Basel III¹ issued by the Basel Committee on Banking Supervision (Basel Committee) and endorsed prior to release by the Group of 20 (G20). Australia is a member of both the Basel Committee and the G20.

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

APRA is also empowered under the *Financial Sector (Collection of Data) Act 2001* (FSCODA) to make reporting standards requiring regulated entities to submit specified data through various reporting forms. Data from these forms are used internally to assist APRA's supervisory functions. Under FSCODA, APRA also collects and refers data to other agencies such as the Reserve Bank of Australia (RBA) and the Australian Bureau of Statistics (ABS).

APRA regularly reviews its prudential and reporting requirements, making amendments as a result of a number of factors including:

- international developments;
- changes in financial market conditions or changes in risk management practices;

¹ Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems*, revised version June 2011: <http://www.bis.org/publ/bcbs189.pdf> (Basel III or Basel rules text).

- in response to identified weaknesses in the prudential framework; and/or
- to reduce potential negative impacts of emerging industry issues.

Problem

Background: APRA's existing capital framework

One of the key components of APRA's prudential framework is the suite of prudential standards that require ADIs to hold regulatory capital as a buffer against the risks that they undertake (capital standards). APRA's capital standards for ADIs follow closely those set by the Basel Committee. In particular, they give effect to two international capital accords: the 1988 Basel Capital Accord (Basel I) and the *International Convergence of Capital Measurement and Capital Standards* (Basel II), which was first released in 2004. The capital regime outlined in these accords was always intended to be evolutionary in nature and subject to ongoing review to take account of market developments and other factors. Both Basel I and Basel II were designed to increase the harmonisation of regulatory capital requirements around the world and to make them more sensitive to risk. The move from Basel I to Basel II represented a substantial shift in the global approach to capital management.

APRA implemented the Basel II framework through prudential standards and PPGs that took effect from 1 January 2008. Further measures (the Basel II enhancements) introduced by the Basel Committee soon after the global financial crisis refined the existing framework and came into effect in Australia on 1 January 2012.

There are three 'Pillars' of the Basel II framework: Pillar 1 sets out minimum capital requirements to address credit, operational and market risk; Pillar 2 outlines the supervisory review process (including supervisory discretion to set higher capital requirements where necessary); and Pillar 3 seeks to impose market discipline through disclosure requirements.

As at June 2012, there were 128 locally-incorporated ADIs subject to APRA's capital framework.

The global financial crisis²

A strong and resilient banking system is the foundation for sustainable economic growth as banks are at the centre of the credit intermediation process between savers and investors. Moreover, banking institutions provide critical services to consumers, small and medium-sized enterprises, large corporate firms and government who rely on them to conduct their daily business, both at a domestic and international level.

One of the main reasons the economic and financial crisis, which began in 2007, became so severe was that the banking sectors of many countries had built up excessive on- and off-balance sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banking institutions were holding insufficient liquidity buffers. Banking systems therefore were not able to absorb trading and credit losses. The crisis was further amplified by a pro-cyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. At the height of the crisis, the market lost confidence in the solvency and liquidity of many banks. Weaknesses in a number of banking systems were rapidly transmitted to the rest of the financial system

² The following section is based on the introduction to the Basel rules text, paragraphs 1-5.

and the real economy, resulting in a massive contraction of liquidity and credit availability. In many countries, the public sector had to intervene with unprecedented injections of liquidity, capital support and guarantees, exposing taxpayers to large contingent liabilities and losses.

The effect on banks, financial systems and economies at the epicentre of the crisis was immediate. However, the crisis also spread to a wider circle of countries around the globe. For these countries, the transmission channels were less direct, resulting from a severe contraction in global liquidity, cross-border credit availability and demand for exports.

Australia was not immune from these impacts, although the root causes of the crisis – lax underwriting standards in the United States sub-prime mortgage sector and poor risk management of exposures to complex structured securities collateralised by sub-prime mortgages – had no widespread parallels in Australia. Australia's experience of the global financial crisis was also supported by a combination of factors including a strong pre-crisis economy, powerful and timely fiscal and monetary policy actions, and a prudential framework in which APRA engaged in strong supervision backed by a Basel II implementation with a small number of more conservative modifications, some of which would later be adopted within the Basel III framework.

For ADIs in Australia, the crisis was mainly a liquidity crisis, resulting from the severe contraction in global liquidity mentioned above. This crisis was initially managed by extraordinary intervention by the RBA. By October 2008, however, it was necessary for the Commonwealth to provide a guarantee of deposits and wholesale funding. This guarantee proved pivotal in assuring ADIs' access to funding and ADIs raised over \$155 billion in government-guaranteed large deposits and wholesale funding. Eventually, as markets stabilised, the guarantee was removed for new liabilities from March 2010.

A legacy of the crisis is significantly higher wholesale funding costs for ADIs. Before the crisis, a number of ADIs became more dependent on offshore wholesale funding to augment traditional retail deposit bases and some ADIs made extensive use of securitisation markets to fund their residential mortgage lending. The global souring of confidence in banks and in structured credit arrangements has resulted in large increases in wholesale funding costs, particularly for longer maturities, and reduced access to longer-term funding sources, other than for the most highly rated banks. During the crisis, securitisation markets virtually ceased to function, and have not yet returned to normal. To maintain some level of securitisation activity, particularly for smaller ADIs and non-ADI mortgage lenders, the Treasurer has directed the Australian Office of Financial Management (AOFM) to invest up to \$20 billion to support securitisation markets.

During the crisis certain types of instruments that were included in Basel II regulatory capital did not behave as intended. Capital is intended to absorb losses and allow an institution to remain viable. Under the Basel II framework, substantial proportions of the capital requirement can be met by lower quality capital instruments such as various forms of preference equity and subordinated debt. Under stress, particularly for those institutions that were bailed out by governments, these instruments did not absorb losses and thus the level of protection afforded by a given level of capital was lower than it appeared before the crisis.

Some of the fundamental factors that contributed to the global financial crisis – insufficient regulatory capital and poor quality loss absorption of the capital base – are direct results of weaknesses now exposed in the existing global regulatory framework, Basel II. Given the impact of financial crises and the global nature of the financial system, it is critical that all countries, including Australia, raise the resilience of their banking sectors to both internal and external shocks.

APRA notes that these weaknesses in the Basel II framework were not exposed in Australia, primarily due to the underlying strength of the Australian economy and the fiscal and monetary policy actions by which Australia avoided a recession and thus avoided the severe losses incurred by banks in other jurisdictions. The Basel II flaws mentioned above only become obvious when banks suffer severe, typically credit-related, losses.

Further, the Australian banking system is highly regarded internationally, in part because of APRA's comprehensive and timely adoption of previous iterations of the Basel capital framework. The four major Australian banks are in the top 20 international banks by market capitalisation and are among the most highly rated in the world. This reputation would be at risk if Australia did not adopt international best practice prudential rules. A likely consequence would be higher funding costs as investors demand greater return for what would be perceived to be a higher risk investment. Such an outcome may occur regardless of whether an issuing ADI is in financial difficulty or whether there is an economic crisis.

Basel III

The Basel III capital reforms are international banking supervisors' response to deficiencies in the regulatory capital framework identified during the global financial crisis. These reforms were endorsed prior to release by the G20³, of which Australia is a member. APRA, as a member of the Basel Committee, played an active role in formulating the Basel III measures.

Basel III is not a wholesale reworking of the international capital framework. The underlying principle – that regulatory capital is determined by reference to the risks ADIs face and the assets they hold – remains the same. In other words, the framework remains risk-based and continues to require banking institutions to hold minimum levels of capital that meet specific criteria. However, Basel III addresses deficiencies in the Basel II framework identified during the global financial crisis by introducing more stringent criteria for inclusion in regulatory capital and by requiring higher minimum levels of that capital to be held against risk. An important new element of the regulatory capital qualifying criteria for preference equity and subordinated debt is that Basel III seeks to protect the potential investment of public money in an ailing ADI, by requiring investors in such capital instruments to bear losses through conversion or write-off provisions before the injection of public funds.

Basel III also includes measures to:

- improve the risk coverage of the Basel II framework by strengthening the capital requirements for counterparty credit risk exposures arising from derivatives, repurchase transactions and securities financing activities;

³ At the Seoul summit of 12 November 2010: <http://www.g20.utoronto.ca/2010/g20seoul.html>

- introduce a leverage ratio as a supplementary measure to the risk-based Basel II framework to help contain the build-up of excessive leverage in the banking system and safeguard against model risk and measurement error; and
- introduce a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress.

Objectives of APRA's initiative

By adopting Basel III in Australia, APRA's objectives are to give effect to Australia's G20 commitment and, in particular, to:

- address deficiencies in the Basel II capital framework highlighted by the global financial crisis with a view to reducing the risk of ADI failure and promoting financial system stability;
- continue to align APRA's capital adequacy regime with international best practice, maintain the high international reputation of the Australian banking system and thus ensure continued participation by ADIs in overseas funding markets; and
- reduce the likelihood of the need for (and degree of) government intervention or support for ADIs in any future financial crisis.

Measures to improve the quality of capital such that it is more loss absorbing in any future crisis are:

- an increase in the proportion of regulatory capital that must be met by common equity;
- conversion or write-off triggers on non common equity regulatory capital to ensure such capital is loss absorbing when an ADI is in serious financial difficulty; and
- a stricter approach to regulatory adjustments (e.g. for intangible assets) under which deductions are to be from common equity rather than mostly from non-common equity capital under Basel II.

Measures to increase capital levels as buffers against ADI losses and financial instability in a crisis are:

- increasing the minimum amounts of capital ADIs must hold against the risks they face. Common equity must be at least 4.5 per cent of risk-weighted assets and the Tier 1 capital ratio (which includes common equity) must be six per cent. (This compares with minima of two⁴ and four per cent, respectively, that apply currently under Basel II.) The total capital ratio remains unchanged at eight per cent by including at most two per cent of so called Tier 2 capital; and
- a new capital conservation buffer set at 2.5 per cent above these minima, to be met by common equity. When capital levels fall within the buffer range, ADIs will be subject to constraints on capital distribution that increase in severity as the buffer reduces.

A countercyclical buffer of up to a further 2.5 per cent (again to be met by common equity) will apply when excessive credit growth and other indicators point to a

⁴ APRA's Basel II implementation requires three per cent common equity.

system-wide build-up of risk. This buffer is designed to address excessive and rapid credit growth that can contribute to any future economic and financial crisis.

To prevent the build-up of excessive on- and off-balance sheet leverage, Basel III proposes a simple maximum leverage ratio of three per cent, based on Tier 1 capital, to augment the risk-based approach to regulatory capital.

Basel III also introduces an additional capital charge, known as the Credit Value Adjustment (CVA) risk capital charge for derivatives, repurchase transactions and securities financing activities, to address problems that arose during the global financial crisis where capital requirements for counterparty credit risk were found to be insufficient.

Basel III provides national supervisors with discretion to provide some limited recognition of certain items in calculating common equity regulatory capital. These items are deferred tax assets relating to timing differences, significant investments in the common shares of non-consolidated financial institutions and mortgage servicing rights. APRA does not propose to exercise this discretion (known in Basel III as ‘the threshold treatment’) but to require that these items be deducted in full from common equity. A principal objective of APRA’s prudential capital framework is to ensure that, for the protection of depositors and the stability of the financial system, capital must be available to absorb losses in a gone-concern scenario (or leading up to that point). In addition, APRA’s framework seeks to ensure that there is no double-counting of capital in the financial system. The threshold treatment would not be consistent with those objectives.

APRA is also proposing an accelerated implementation timetable for some aspects of the Basel III reforms. To accommodate the varying Basel II implementations in place around the world and the health or otherwise of various banking systems, the Basel Committee allows many of the reforms to be introduced over a period of years from January 2013. However, national supervisors are encouraged to introduce the reforms earlier where this is appropriate. In APRA’s view, ADIs in Australia should have little difficulty in meeting many of the new requirements and thus APRA intends an accelerated implementation timetable for the minimum amounts of capital, regulatory adjustments and the capital conservation buffer.

To implement the Basel III capital reforms in Australia, changes are required to be made to the following prudential standards and related reporting standards:

- *Prudential Standard APS 110 Capital Adequacy (APS 110);*
- *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111);*
- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112);*
- *Prudential Standard APS 113 Capital Adequacy: Internal Ratings Based Approach to Credit Risk (APS 113);*
- *Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116);*
- *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs) (APS 117);*
- *Prudential Standard APS 120 Securitisation (APS 120); and*

- *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (APS 330).

The introduction of Basel III in Australia also necessitates a new reporting standard, *Reporting Standard ARS 111 Fair Values* (ARS 111) and minor changes to many other prudential and reporting standards.

Options

APRA has identified four options:

- maintain APRA's existing prudential framework;
- implement some of the Basel III measures;
- fully implement Basel III; or
- implement stronger measures than proposed by Basel III.

Impact analysis

Assessment of costs and benefits

There are two types of cost for ADIs that are relevant to any discussion on implementing Basel III: the cost of increased loss-absorbing capital and compliance costs. As part of the consultation process, APRA invited submissions on the impact of implementing Basel III in these two areas, including a specific invitation to use the OBPR's Business Cost Calculator (BCC). APRA received minimal cost/benefit feedback from affected institutions and no ADI used the BCC. Other information was submitted by larger ADIs through a number of Quantitative Impact Studies (QIS) initiated by the Basel Committee.

In the absence of data provided by ADIs, it is difficult for APRA to be able to estimate the compliance costs of adjusting to the Basel III capital reforms. APRA notes, however, that the Basel III capital regime, while more restrictive than the Basel II regime in some aspects, is not in totality materially more complex. Thus, APRA does not expect that ADIs would incur materially higher compliance costs under APRA's Basel III proposals.

However, increased levels of loss-absorbing capital do potentially impose business costs that ADIs may seek to pass onto customers. APRA's view is that these costs are minor relative to the potential benefits from a safer financial system.

Option 1 – maintain APRA's existing prudential framework

The potential costs of this option are extreme, but long term and latent as they are not immediately ascertainable.

The global financial crisis exposed weaknesses in the Basel II regulatory framework that strongly contributed to the severity of the crisis. Australia's current prudential framework is closely aligned with Basel II and contains those same weaknesses. Whilst, for a variety of reasons, Australia's experience of the crisis was less severe than some jurisdictions, Australia should not rely on those same factors being present for the next crisis. The weaknesses in Australia's prudential framework need to be addressed.

Furthermore, this option would be at odds with Australia's G20 commitment to implement the Basel III reforms no later than the internationally agreed timeframe;

leaving Australia as the only member of the G20 that would not follow through on the commitment made at the Seoul summit of November 2010.

Also, if Option 1 were pursued, internationally active ADIs would likely suffer increased funding costs because Australia's regulatory regime would be less robust than international best practice and global investors would seek higher returns to compensate for the increased risk. Such higher funding costs would negatively affect ADI profitability or be passed onto customers.

In addition, foreign bank branches operating in Australia would potentially be at a competitive disadvantage compared to Australian ADIs (whether internationally active or not) as foreign bank branches will effectively be subject to Basel III via their home jurisdictions.

Maintaining APRA's current prudential regime would only have an immediate flow-on effect to ADI customers via potentially increased funding costs as outlined above, but would expose ADI customers to a greater risk of institutional failure and expose Australians generally to a greater risk of systemic instability. As can currently be observed in other jurisdictions (e.g. Spain, Ireland, UK), those costs can be extreme.

Option 2 – partially implement Basel III

APRA is of the view that partially implementing Basel III would not present material advantages to ADIs or the community in general. The Basel III measures address interlinked weaknesses in the current prudential framework. Failure to implement one element of the package would undermine the effectiveness of those elements which were implemented.

Option 3 – fully implement Basel III

APRA's analysis is that ADIs are well placed to meet the new requirements from 1 January 2013. For example, most ADIs already meet the higher minimum common equity requirements and will have until January 2016 to raise the capital necessary to meet the capital conservation buffer. This extra capital requirement will be largely generated by retained earnings without serious erosion of dividend pay-out ratios. Further, APRA is allowing long transition arrangements for some aspects, such as the regulatory treatment of instruments that qualified as capital under Basel II but do not qualify under Basel III.

APRA acknowledges that adjusting to the reforms will also impose some compliance costs as ADIs change their current processes and systems, but these are not seen as material. Changes to existing reporting requirements are minimal and only one new form will be introduced. Once these adjusted processes and systems are in place, however, there should be little difference in on-going compliance costs from those arising now.

There is a long-term economic impact of the Basel III reforms⁵. The 'cost' impact in the chain of economic effects of higher regulatory capital ratios is:

- higher equity ratios for ADIs;
- higher weighted funding costs (including debt and equity funding) and lower return on equity;

⁵ Refer to Basel Committee, *An assessment of the long-term economic impact of the new regulatory framework*, August 2010, <http://www.bis.org/publ/bcbs173.pdf>

- banking institutions increase lending rates to restore some of their lost return on equity;
- borrowers increase their aggregate borrowings more slowly than would otherwise have been the case; and
- gross domestic product (GDP) grows more slowly than would otherwise have been the case, for most of the business cycle.

The 'benefit' chain is:

- higher equity ratios for ADIs;
- safer ADIs, which can therefore borrow funds and raise capital more cheaply;
- reduced failure of ADIs and impairment rates; and
- reduced risk and potential depths of financial crises.

To assist in this analysis, APRA specifically invited ADIs to determine the expected impact on loan pricing as a result of an increase in the minimum required common equity capital ratio. ADIs responded with estimates on the increased cost to a typical mortgage of around 10 basis points if the required common equity capital requirement increased by 200 basis points. However, APRA estimates that the cost to a typical mortgage would be (at most) around five basis points on a full cost-recovery basis. APRA's analysis is included in Attachment A⁶.

Against this, higher regulatory capital requirements are designed to make Australia's banking institutions safer and, accordingly, enjoy comparatively lower funding costs, more access to funding and, to some extent, a lower required return on equity. These benefits are appreciable but difficult to calculate in the context of any specific banking institution's cost of equity and cost of funding. These issues should be considered in the context of Basel Committee estimates that a financial crisis occurs every 20 to 25 years, resulting in estimated losses of between 10 to 50 per cent of GDP. APRA notes that Australia's experience does not accord with these estimates: the last systemic banking crisis occurred in the 1890s while the last banking failures (which were outside the prudential regulation system applicable then) were in the early 1990s.

Statistically, Australia's economy and banking system will be more often exposed to a typical recession rather than an atypical crisis. However, in the event of a recession, a more strongly capitalised banking industry will be materially better placed to maintain its funding and capital access, which in turn will better support those who rely upon the banking system for their own funding and savings needs.

APRA notes the view of the International Monetary Fund (IMF), expressed in Chapter 3 of its recent *Global Financial Stability Review*⁷, that 'assessments of the economic costs and benefits, both transitional and long term, of the Basel III capital and liquidity standards have shown that the long-term benefits vastly exceed the transitional costs'. Nevertheless, the IMF has observed that banks may respond to regulatory change with innovative product design in an attempt to circumvent the new requirements and that, in addition, some risk-taking activities may move to the non-

⁶ See also *The Impact of the Basel III Capital Reforms in Australia*, APRA Insight Issue 2 2012, <http://www.apra.gov.au/Insight/Pages/default.aspx>

⁷ Refer to IMF *Global Financial Stability Report: Restoring Confidence and Progressing on Reforms*, October 2012, chapter 3: <http://www.imf.org/External/Pubs/FT/GFSR/2012/02/pdf/c3.pdf>

bank sector. APRA acknowledges that these risks are attached to any change in the regulatory framework and APRA is watchful of such developments. In APRA's view, these risks are less prominent in Australia — given the structure of the financial system — than in many other jurisdictions, where, for example, shadow banking has a significant and long standing presence.

APRA's view accords with that of the IMF in that the immediate costs are minor and outweighed by the benefits of maintaining an appropriately conservative level of banking regulation in Australia. The Basel III reforms were developed in response to deficiencies in the current capital framework identified during the global financial crisis, which saw the collapse of banking institutions across the world and significant detriment to individual economies. APRA agrees with the Basel Committee's assessment of these deficiencies and is of the view that implementing the reform measures in Australia will make the Australian banking system more resilient to future financial crises. Preventing ADI failure is of direct benefit to depositors and shareholders of the institution involved while protecting the banking system is of benefit to the whole community.

The reforms will benefit ADIs in other ways. The global financial crisis demonstrated the importance of market sentiment in maintaining the banking sector. Choosing not to implement Basel III in circumstances where other jurisdictions do implement these reforms would probably lead to the market perception that Australian ADIs were exposed to higher risk. This perception would place these ADIs at a competitive disadvantage relative to overseas peers and result in lower credit ratings and increased wholesale borrowing costs. Adopting the new minimum capital levels and regulatory adjustment requirements at the earliest start dates applicable under the Basel III timetable benefits ADIs in demonstrating their already sound capital position.

Option 4 - implement stronger measures than proposed by the Basel Committee

APRA's general regulatory approach is to at least adopt the minimum standards applicable globally, and where there is good reason to do so, adopt a relatively conservative application of these standards. In the case of Basel III, however, APRA has in general elected to implement the international standard as-is, albeit exercising the discretions available within Basel III to ensure that Australia remains positioned relatively conservatively in global terms.

APRA is comfortable that its proposed implementation of Basel III sufficiently addresses the weaknesses identified in the existing capital standards. APRA needs to maintain a balance between the need for prudential safety and economic efficiency for ADIs. If APRA was to impose significantly more conservative standards than Basel III, which would further increase the capital levels of ADIs, this may discourage foreign ADI subsidiaries from entering or continuing their business in Australia. In addition, the incremental costs of the extra conservatism may not be offset by the need to address residual deficiencies in the regulatory framework. APRA does not believe it is appropriate to implement requirements that become economically prohibitive.

Consultation

During its review of the current capital adequacy framework, the Basel Committee invited public comment and sought quantitative data on its proposals. Of a series of consultative documents issued publicly, the December 2009 *Strengthening the*

*resilience of the banking sector*⁸ set out in detail the proposed capital reforms. Over 200 submissions received through this process (including from ADIs in Australia and Australian industry groups) were published in April 2010⁹.

APRA has also undertaken extensive consultation on the proposed implementation of the Basel III capital reforms in Australia, beginning with a series of letters to the ADI industry in 2009.

APRA's formal public consultation consisted of the following:

- September 2011: *Implementing Basel III capital reforms in Australia* (discussion paper);
- March 2012: *Implementing Basel III capital reforms in Australia* (first response to submissions paper and draft prudential standards);
- June 2012: *Basel III capital reforms reporting requirements* (discussion paper and draft reporting standards);
- June 2012: *Basel III Capital - Governing law and joint arrangements* (letter to industry);
- August 2012: *Basel III capital: counterparty credit risk and other measures* (discussion paper, draft prudential standards and reporting standards);
- August 2012: *Basel III capital – reductions in capital* (letter to industry);
- September 2012: *Implementing Basel III capital reforms in Australia* (second response to submissions paper, prudential and reporting standards); and
- November 2012: *Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures* (response to submissions paper, prudential and reporting standards, prudential practice guides and revised *Guidelines on Recognition of an External Credit Assessment Institution*).

APRA engaged directly with relevant industry associations as part of the consultation process, made presentations at industry conferences and held industry seminars on Basel III in conjunction with the Financial Services Institute of Australasia (Finsia).

APRA has also consulted on the proposed amendments to the reporting standards with the RBA and ABS. No concerns were raised by these agencies.

Industry supports APRA's implementation of Basel III and few written submissions were received on the various consultation packages. There were requests for clarification on a number of technical aspects. More significant matters raised in submissions were:

- requests for APRA to facilitate cross-border comparisons of ADIs' capital ratios. Basel II and Basel III provide national supervisors with discretion over the approach to particular technical matters. APRA has traditionally taken a conservative approach to the exercise of these discretions, which served the Australian banking sector well during the global financial crisis but means that ADIs appear to be less well capitalised than they would if operating in other countries that took a different stance on these discretions. The Basel Committee

⁸ <http://www.bis.org/publ/bcbs189.htm>

⁹ <http://www.bis.org/publ/bcbs165/cacomment.htm>

has released a common template to enable international comparability, which APRA proposes to implement in June 2013;

- APRA's *in-principle* decision not to exercise its discretion and adopt the threshold treatment of investments in non-consolidated financial institutions and deferred tax assets. APRA's view is that capital should be available to absorb losses and should not be double-counted; and
- the particular difficulties faced by ADIs with a mutual corporate structure, which are unable to issue ordinary shares. APRA acknowledges this concern and is consulting separately with mutual ADIs.

The proposal to amend APS 120 in relation to subordinated tranches was included as a separate chapter in APRA's November 2011 Discussion Paper *Covered bonds and securitisation matters* and the proposed text of APS 120 was included in the July 2012 paper, *Response to Submissions Covered bonds and securitisation matters*. It was also included in the August 2012 discussion paper *Implementing Basel III Capital Reforms in Australia – counterparty credit risk and other measures*.

Conclusion and recommended option

During the global financial crisis, deficiencies in the Basel II framework led to significant institutional failure and financial instability across a number of overseas jurisdictions. Fortunately, there was no Australian financial crisis and, in particular, no Australian banking crisis. The absence of an Australian banking crisis is explained, firstly, by preventive action in the years before 2008 and, secondly, by extraordinary public sector intervention from 2008.

The major preventive actions included:

- a relatively benign economic environment;
- the generally sound management of Australian ADIs, which did not seek to add unsustainably risky assets to their balance sheets or engage in the type of lax lending practice that occurred overseas;
- proactive APRA supervision, with a focus upon maintaining sound asset quality and adequate capital strength; and
- a more conservative adoption of the Basel II requirements, many of which are reflected in the Basel III measures.

The major public sector interventions during the crisis, including RBA liquidity support and Government guarantee programs, were in response to the impact on liquidity on the Australian banking system caused by the global crisis while other monetary and fiscal actions assisted the economy more broadly.

Future adversity may well arise during or due to material reverses in the Australian economy, such as a severe or lengthy recession. Under such conditions, the capital stress upon Australian ADIs would likely be much higher than was the case in the global financial crisis, and the current Australian Basel II framework may be insufficient to withstand this stress. The Basel III framework provides both more

capital, and higher quality capital, in a fashion that will lift the safety and systemic stability of Australia's ADIs in any future Australian economic adversity.

Although APRA was more conservative than other countries in its implementation of the Basel II framework, the shortcomings of Basel II are reflected in the current capital requirements applying to ADIs in Australia. There is no guarantee that the same factors that protected the Australian banking system during the recent crisis would be relevant in a future financial crisis.

It is also important that the Australian banking system remains in step with international requirements. If the Australian regulatory framework is judged to be weaker than international norms, the cost of funding for Australian ADIs may increase, leading to flow-through costs to Australian investors and depositors. ADIs cannot simultaneously rely on cross-border funding *and* seek to be exempted from some or all of the internationally applicable regulatory reforms. Failing to adopt Basel III would also send negative messages to overseas markets and ratings agencies. It is possible that ADIs would experience ratings downgrades and loss of investor confidence, which would also increase funding costs.

None of these benefits has been quantified but they are likely to be material. However, the benefits need to be balanced against the fact that the proposed adoption of Basel III could impose costs on borrowers in the form of an increase in lending rates of between 5 and 10 basis points, at most, since these estimates do not account for any reduction in risk premia.

APRA therefore does not support retaining the existing Basel II framework and notes that this is also industry's position. There is also no appetite for partially implementing the new measures: doing so would achieve little as the Basel III reforms are an interlinked package. Nor is there presently a rationale for introducing new measures beyond those included in the Basel III package. APRA therefore proposes to adopt Option 3.

Implementation and Review

The Basel III capital reforms will be implemented from 1 January 2013 through prudential standards, reporting requirements and PPGs applying to ADIs in Australia.

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

Attachment A: Loan pricing effects of Basel III implementation

Cost of equity

In considering the cost of equity, it is important to distinguish between a banking institution's cost of equity and its aspirational return on equity. Broadly, the cost of equity is the rate of return necessary to meet shareholder expectations; this could also be thought of as the return necessary to avoid a reduction in share price. The aspirational return on equity is the amount that a banking institution seeks to earn in order to create additional wealth for shareholders.

This raises the question that, when faced with a regulatory imposition of more equity than the banking institution would otherwise hold, should the resultant loan pricing reflect the cost of equity, or the aspirational return on equity? In APRA's view, the appropriate basis for any increases in lending rates arising from such a regulatory imposition should be the cost of, not the aspirational return on, that extra equity.¹⁰ This is the approach APRA is taking in its cost/benefit calculations. Based on indications from the larger banking institutions, the cost of equity is assumed to be around 16 per cent pre-tax.

Saved debt funding cost

As an example, assume that a banking institution before Basel III is funding loans with \$93 in borrowings and \$7 in equity, and after Basel III it will fund with \$91 in borrowings and \$9 in equity. This institution needs to find \$2 in additional equity, which will have its costs, but can forego the need for \$2 in borrowings, which saves the interest that would otherwise be paid on those borrowings.

Risk-free rates in Australia have fallen recently, but the incremental cost of bank borrowing over the risk-free rate has increased. For illustrative purposes, assume that the incremental cost of borrowing saved by an increase in equity funding is six per cent per annum pre-tax. The cost saved is not the bank's average borrowing cost but its most expensive incremental borrowing source.

The assets to 'risk-weighted assets' adjustment

Under Basel II and Basel III, all banking institution exposures are adjusted to a risk-weighted asset equivalent. The mechanics of this adjustment are beyond the scope of this RIS but, in aggregate, risk-weightings are considerably less than the actual loan amounts. For the larger banks, average risk-weightings are on the order of about 20 per cent of the loan amount for home loans and around 50 per cent for other loans.¹¹

Loan pricing arithmetic

From the previous sections, the necessary arithmetic to calculate incremental loan pricing effects from APRA's Basel III implementation can be assembled. The calculation for this illustration is:

Loan rate increase = Extra equity x (Cost of equity – saved funding cost) x risk-weighting.

¹⁰ Assuming banks can pass on in full the costs of equity between borrowers and depositors, the costs should be borne by borrowers or shareholders as no capital requirement is imposed for deposits. Note that the costs may not be passed on in full, depending upon the degree of competition within lending markets.

¹¹ Estimates taken from APRA statistical data.

On the assumptions made in this paper, for the average non-housing loan this calculation generates:

$$2\% \times (16 - 6)\% \times 50\% = 0.10\% \text{ per annum.}$$

For a home loan with a 20 per cent risk-weighting, the calculation would be:

$$2\% \times (16 - 6)\% \times 20\% = 0.04\% \text{ per annum.}$$

From the above formulae, the estimated loan rate increase attaching to a two per cent common equity ratio increase, for an average loan in a large Australian bank's portfolio, would be on the order of 0.10 per cent per annum. The increase for a home loan on typical risk-weightings would be around 0.04 per cent per annum.

Differing assumptions could be used for the above calculations. Whatever assumptions are made, however, the critical outcome is that the loan pricing effects of APRA's requirement that banks hold more capital than they might prefer are very small. The changes in the risk-free rate, and recently the changes in funding costs over the risk-free rate, dwarf any reasonable estimate of the loan pricing effects associated with additional capital requirements.