



John F. Laker AO
CHAIRMAN

31 May 2012

Committee Secretary
Senate Standing Committee on Economics
Department of the Senate
PO Box 6100 Parliament House
CANBERRA ACT 2600

Dear Sir,

INQUIRY INTO THE POST-GFC BANKING SECTOR

This letter and submission have been written to assist the Senate Standing Committee on Economics in its inquiry into the post-GFC banking sector.

APRA's comments are limited to the following item in the terms of reference:

- (a) the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements.

The major international regulatory changes that will underpin the financial strength of the Australian banking system in coming years are, of course, the reform measures announced by the Basel Committee on Banking Supervision in December 2010 to strengthen global capital and liquidity rules. These so-called Basel III reforms are a response to the global reform agenda established by the Leaders of the G-20 in their April 2009 Declaration, *Strengthening the Financial System*. Australia has committed itself to the G-20 reform agenda and, as a member of the Basel Committee, APRA itself has been actively involved in developing the Basel Committee's reform measures and fully supports their implementation in Australia.

The transition process to the new global capital and liquidity regime does not begin until 1 January 2013. Hence, any assessments of the 'impact' of this new regime can be indicative only. APRA is conducting a detailed cost/benefit and impact analysis as it progresses the Basel III reforms in Australia. That said, APRA's view is that the Basel III reforms will clearly strengthen the capital and liquidity buffers held by the Australian banking system to cope with stresses, with only a limited impact on the cost of equity and liquidity.

APRA staff would be happy to appear before the Committee if that would be helpful.

Yours sincerely,



Australian Prudential Regulation Authority

Inquiry into the post-GFC banking sector

Submission to the Senate Economics References Committee

31 May 2012

INQUIRY INTO THE POST-GFC BANKING SECTOR

I. Introduction

APRA is the prudential regulator of banks, credit unions and building societies (collectively, 'authorised deposit-taking institutions' or ADIs) in Australia. Its core mandate is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the financial institutions it supervises are met within a stable, efficient and competitive financial system. The prudential framework for ADIs has been in place for a number of years, certainly pre-dating the global financial crisis, and it is built upon the key planks of capital, liquidity, risk management and governance.

This submission outlines the changes to the prudential framework for ADIs flowing from global regulatory reform initiatives. It focuses on three main initiatives in the global banking system:

- (i) reforms to global capital standards;
- (ii) the introduction of new global liquidity standards; and
- (iii) the promotion of prudent principles for executive remuneration.

APRA has discussed these reform initiatives extensively in its consultation packages, speeches and presentations to industry fora. This submission provides a summary of their main features.

The composition of the ADI industry¹ at the end of 2011 is shown in Table 1.

Table 1: Composition of the ADI industry in Australia: December 2011

	Number	Assets (\$A million)	Market share (%)
Major banks*	5	2,032,789	77
Other Australian-owned banks	10	219,867	8
Branches of foreign banks	39	201,397	8
Subsidiaries of foreign banks	9	106,826	4
Credit unions	97	53,650	2
Building societies	9	21,104	1
TOTAL	169	2,635,633	

* Includes Bank of Western Australia, a subsidiary of the Commonwealth Bank of Australia

II. Reforms to global capital standards

The Basel II Framework

Capital is the cornerstone of an ADI's financial strength and provides a buffer to absorb unanticipated losses. Over a long period, APRA's capital requirements have been based on global standards introduced by the Basel Committee on Banking Supervision (Basel Committee).

¹ Excluding Cairns Penny Savings & Loans Limited, Australian Settlements Limited, Cuscal Limited, Indue Limited, specialist credit card institutions and providers of purchased payment facilities.

Until 1 January 2008, APRA's capital adequacy framework was based on the original 1988 Basel Capital Accord, which had been developed out of a desire to align the capital requirements of banks that competed across national boundaries. Over time, however, the 'one size fits all' approach of the Accord proved unable to deal with the increasing innovation and sophistication of the marketplace. From 1 January 2008, a new global capital adequacy regime, known as the Basel II Framework, was implemented in Australia. The Basel II Framework seeks to harness into the regulatory process best practices in risk management and to provide prudential capital requirements that are both more comprehensive and more sensitive to risks.

The Basel II Framework, which remains the core of APRA's capital adequacy framework, is built on three pillars. It requires ADIs to hold regulatory capital against credit risk, operational risk and market risk (Pillar 1) and introduces a supervisory review process that seeks to ensure that ADIs have adequate capital to support all the risks in their business and to encourage them to develop and use better risk management techniques (Pillar 2). Pillar 3 requires disclosures to allow market participants to assess key information such as risk exposures, risk assessment processes and capital adequacy.

The G-20 reform agenda

One of the main contributing factors to the global financial crisis was the excessive leverage (borrowing) built up by banking systems in a number of countries, accompanied by a gradual erosion of the level and quality of regulatory capital held. Liquidity buffers in many global banks were also insufficient. As a consequence, banking systems in a number of countries were unable to cope with large trading and credit losses, particularly in structured credit instruments, or with the massive contraction of liquidity as investors lost confidence in the solvency and liquidity of many banking institutions.

In response to these failings, the Leaders of the G-20, in their Declaration *Strengthening the Financial System* (April 2009), committed to a global reform agenda that would involve, *inter alia*, improving the quality, quantity and international consistency of capital in the global banking system and promoting stronger liquidity buffers. The Basel Committee on Banking Supervision has had carriage of these reforms. Over the past three years, it has pursued a comprehensive reform program aimed at increasing capital and liquidity buffers held by internationally active banks, improving risk management and governance, and enhancing banks' transparency. As a member of the Basel Committee, APRA has been actively involved in these initiatives.

Enhancements to the Basel II Framework

As the first stage of its comprehensive reform program, the Basel Committee announced a package of measures to enhance the three Pillars of the Basel II Framework in July 2009 (as adjusted in June 2010). These enhancements, known as 'Basel II.5', included, under Pillar 1, an improved coverage of risks arising from complex structured products and from securitisation as well as higher capital for market risk, resulting in part from the requirement to use data from periods of financial stress in the modelling of such risk. Under Pillar 2, supplementary guidance was issued to address flaws in risk management practices revealed by the global financial crisis. The guidance covers institution-wide governance and risk management processes, management of risk concentrations and the capture of risk from off-balance sheet and securitisation activities. Enhancements to Pillar 3 strengthen disclosure requirements for these same activities. The Basel Committee

expected banks and supervisors to begin implementing the Pillar 2 guidance immediately but set the start-date for the Pillar 1 and Pillar 3 changes at no later than the end of 2010. That date was subsequently deferred by 12 months.

Following consultation with industry, APRA released amendments to relevant ADI prudential standards and prudential practice guides in May 2011 that give effect to these Basel II.5 enhancements. APRA also made other amendments to its capital adequacy requirements for ADIs to clarify existing provisions and to support the implementation of the enhancements. The prudential standards and revised reporting requirements came into effect from 1 January 2012, in line with the internationally agreed timetable. To this point, they have had only a limited impact on ADIs in Australia, which largely avoided higher-risk trading activities in the lead-up to and during the global financial crisis.

Basel III capital reforms

The more significant milestone in the Basel Committee's comprehensive reform program was the release of a package of proposals (now known as 'Basel III') to strengthen capital and liquidity requirements for internationally active banks. This package was released in December 2009 and the Basel III rules text was finalised in December 2010.²

The capital reforms cover a number of key areas and included proposals:

- to raise the quality, consistency and transparency of the capital base and harmonise other elements of capital;
- 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;
- to 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
- to 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. The Basel Committee is also promoting more forward-looking approaches to provisioning for credit losses.

The new minimum capital requirements in Basel III involve:

- a Common Equity Tier 1 Capital ratio (after regulatory adjustments) of 4.5 per cent of risk-weighted assets (compared with two per cent currently);
- a Tier 1 Capital ratio of six per cent (four per cent currently); and
- a Total Capital ratio of eight per cent (unchanged).

Above these new minimum requirements, a capital conservation buffer of 2.5 per cent will apply. When capital levels fall within the buffer range, banking institutions will be subject to constraints on capital distribution that increase in

² *Basel III: A global regulatory framework for more resilient banks and banking systems*, (revised June 2011), <http://www.bis.org/publ/bcbs189.htm>.

severity as the buffer reduces. In addition, a countercyclical buffer of up to 2.5 per cent will apply when excessive credit growth and other indicators point to a system-wide build-up of risk.

The Basel Committee's timetable envisages that implementation of the reforms in member countries will begin on 1 January 2013 and the new minimum capital requirements will be phased-in by 1 January 2015; implementation of the broader package of reforms will be substantially completed by 1 January 2019. However, the Basel Committee also emphasised that national authorities have the discretion to impose shorter transition periods and should do so where appropriate.

In September 2011, APRA released its proposals for implementing the Basel III capital reforms in Australia.³ As with the implementation of the Basel II Framework, the new regime is to apply to all ADIs. APRA proposed to broadly adopt the minimum Basel III requirements for the definition and measurement of capital for ADIs. This would require APRA to amend its current policies in a number of areas, taking a stricter approach than at present in some but a less conservative approach in others. In certain areas, however, APRA saw strong in-principle reasons to continue its current policies and not adopt a concessional treatment available under the Basel III reforms. These areas are the treatment of deferred tax assets, investments in non-consolidated financial institutions and investments in commercial institutions. APRA also proposed to introduce the new Basel III capital buffer regimes and the leverage ratio.

Following industry consultation, in March 2012 APRA released its response to submissions received on the September 2011 discussion paper and five draft prudential standards that will give affect to the Basel III capital reforms in Australia.⁴ The closing date for submissions was 31 May 2012. APRA will consult over coming months on revised reporting standards and consequential amendments to other prudential standards required to implement the Basel III capital reforms.

The Basel Committee has yet to finalise measures to address counterparty credit risk and to enhance disclosure requirements. APRA will consult on the implementation of these measures in Australia once they have been finalised.

Impact of Basel III capital reforms

The Australian banking system is well placed to meet the new Basel III capital requirements. As part of its development of the Basel III reforms, the Basel Committee has conducted a series of quantitative impact studies (QIS), to which a number of larger Australian banks have contributed. The QIS results for these banks have been calculated on the (conservative) basis of:

- full deduction of all regulatory adjustments under Basel III (i.e. no allowance for transition of these adjustments);
- no concessional treatment available under Basel III for certain other items; and

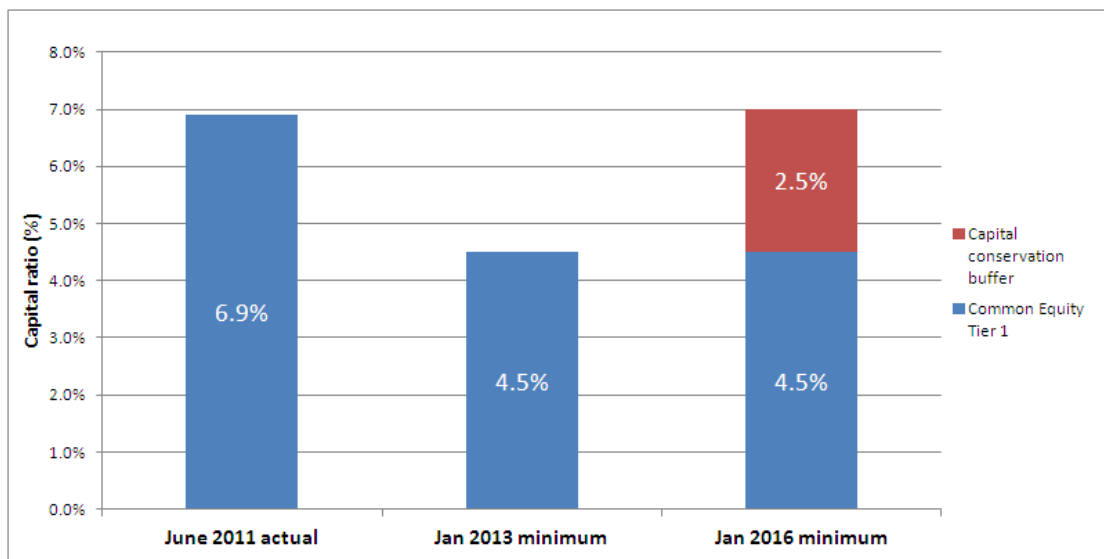
³ Discussion Paper: *Implementing Basel III capital reforms in Australia*, <http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-September-2011.aspx>

⁴ Response to Submissions: *Implementing Basel III capital reforms in Australia*, <http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-March-2012.aspx>

- the continued exercise of the national discretions available under Basel II (e.g. an explicit capital requirement for interest rate risk in the banking book).

The QIS results as at end June 2011 show that the larger Australian banks had a Common Equity Tier 1 Capital ratio of 6.9 per cent (Table 2). This figure is well above the minimum Common Equity Tier 1 Capital requirement of 4.5 per cent, which under the Basel Committee's timetable is to be phased-in by January 2015. The figure is also only slightly below the minimum requirement of a Common Equity Tier 1 Capital ratio, including the capital conservation buffer, of seven per cent, which under the Basel Committee's timetable is to be phased-in between 1 January 2016 and 1 January 2019.

**Table 2: Capital - actual v Basel III minimum
Selected larger banks - end June 2011**



On the basis of these (and earlier similar) results, APRA has proposed an accelerated Basel III timetable in some areas (see Attachment A). In particular:

- ADIs will be required to meet the minimum Common Equity Tier 1 requirement of 4.5 per cent (after regulatory adjustments) in full from 1 January 2013; and
- the capital conservation buffer will apply in full from 1 January 2016.

The larger banks already meet the 2013 target and need take no action. APRA believes that they will be readily able to meet the 2016 target through prudent earnings retention policies. The accelerated timetable is unlikely to impose any burden on smaller ADIs, given their current high capital ratios and generally lower level of regulatory adjustments.

APRA is aware that Singapore, Canada, Sweden and New Zealand have also proposed accelerated implementation timetables.

III. Reforms to global liquidity standards

The comprehensive reform package released by the Basel Committee in December 2009 also included a global framework for promoting stronger liquidity buffers to

ensure that banking systems are more resilient to liquidity stresses. The centrepiece of this framework is a new standard for liquidity risk (the Liquidity Coverage Ratio) that aims to ensure that banking institutions have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. This standard aims to strengthen short-term resilience. A second global standard, the Net Stable Funding Ratio, aims to promote longer-term resilience by requiring banking institutions to fund their activities with more stable sources of funding on an ongoing basis.

In anticipation of the Basel Committee's liquidity reforms, APRA had released a consultation package in September 2009 on proposed enhancements to its prudential framework for ADI liquidity risk management. The key changes involved more demanding stress-testing parameters, introduction of a standardised reporting framework to improve APRA's ability to assess ADIs' liquidity risk profiles, and enhanced qualitative requirements consistent with the Basel Committee's revised *Principles for Sound Liquidity Risk Management and Supervision* (September 2008).

The final rules text for the new global liquidity framework was released by the Basel Committee in December 2010.⁵ The framework incorporates scope for alternative treatments for jurisdictions, such as Australia, that do not have sufficient high-quality liquid assets (particularly sovereign debt) for inclusion in liquidity buffers.

Within that scope, the Reserve Bank of Australia (RBA) and APRA announced in December 2010 that an ADI will be able to establish a committed secured liquidity facility with the RBA. The facility will be sufficient in size to cover any shortfall between the ADI's holdings of high-quality liquid assets and its Liquidity Coverage Ratio requirements (both in domestic currency terms). The facility will incur a market-based commitment fee set by the RBA at 15 basis points. For its part, APRA will require participating ADIs to demonstrate that they have taken all reasonable steps towards meeting their liquidity requirements through their own balance sheet management, before relying on the RBA facility.

In November 2011, APRA released a discussion paper and draft prudential standard setting out its proposals for implementation of the Basel Committee's liquidity reforms⁶. APRA proposes to apply the two new global liquidity standards to the larger ADIs but not to ADIs with simple, retail-based business models, which will remain subject to a simple, quantitative metric, the minimum liquidity holdings regime. APRA's enhanced qualitative requirements will apply to all ADIs. In line with the Basel Committee's timetable, the Liquidity Coverage Ratio (including any revisions) will be introduced on 1 January 2015 after an observation period beginning in 2011. The Net Stable Funding Ratio (including any revisions) will be introduced from 1 January 2018.

Over coming months, APRA will be in active dialogue with the larger ADIs on the use of the RBA facility. As a minimum, ADIs will need to demonstrate that they have increased the duration of their liabilities and maximised reliance on stable sources of funding to the greatest reasonable extent. A key element of this

⁵ *Basel III: International framework for liquidity risk measurement, standards and monitoring*, <http://www.bis.org/publ/bcbs188.htm>

⁶ Discussion Paper: *Implementing Basel III liquidity reforms in Australia*, <http://www.apra.gov.au/adi/PrudentialFramework/Pages/Implementing-Basel-III-Liquidity-Reforms-in-Australia-November2011.aspx>

dialogue will be the risk/return trade-off in lengthening the maturity profile of wholesale funding, which will have a significant bearing on assessments of the impact of the new Basel III liquidity regime. At this stage, APRA's view is that the costs to ADIs of securing much stronger liquidity and funding profiles will be only modest.

IV. Executive remuneration

One other important element of the G-20's reform agenda in response to the global financial crisis is the promotion of prudent principles for remuneration in banking institutions. A global consensus that remuneration arrangements in many global banking institutions encouraged excessive risk-taking, with insufficient regard to longer-term risks, prompted the development of the then Financial Stability Forum's *Principles for Sound Compensation Practices*, published in April 2009, and its *Principles for Sound Compensation Practices – Implementation Standards*, published in September 2009. APRA was a significant contributor to this work.

Taking these *Principles* and *Implementation Standards* as its starting point, APRA introduced prudential requirements on remuneration for ADIs (and general and life insurers) with effect from April 2010. These requirements, which are extensions to APRA's governance standards, address the risk that poorly structured remuneration practices may result in excessive risk-taking by individuals and undermine institutions' risk management systems. APRA did not adopt some of the more prescriptive limits and caps that have been recommended in the *Implementation Standards*, but it is confident that its principles-based approach will achieve the substantive outcomes sought by this global reform initiative.

APRA has taken a principles-based approach on remuneration. Boards of APRA-regulated institutions are required to have an independent Remuneration Committee and a remuneration policy that aligns remuneration arrangements with the long-term financial soundness of the institution and its risk management framework. At the same time, boards are able to design remuneration arrangements that suit the structure of their own institution. The policy extends beyond senior executives to all persons who, because of their roles, have the capacity to make decisions that could materially affect the interests of depositors (or policyholders), and owners. APRA's approach focuses on the incentives built into remuneration arrangements and their alignment with good stewardship of institutions; it is not APRA's role to intrude into the market and shareholder disciplines involved in determining absolute levels of remuneration. Where APRA judges that the remuneration arrangements of a regulated institution are likely to encourage excessive risk-taking, APRA has several supervisory options, including the power to impose additional capital requirements on that institution.

Since its remuneration requirements were introduced, APRA has been building up its understanding of remuneration arrangements in the search for better practice, particularly how institutions incorporate an adjustment for risk in their performance-based compensation schemes. APRA's supervisors have been monitoring progress on implementation, conducting peer comparisons of a number of selected institutions and meeting with a number of Board Remuneration Committees for more detailed review. APRA has recently provided feedback to APRA-regulated institutions on matters that warrant further consideration.

Basel III transition in Australia

	2013-2015	2016 onwards
	Per cent	
Minimum CET1	4.5	4.5
Capital conservation buffer		2.5*
Minimum CET1 + conservation buffer	4.5	7.0
Phase-in of deductions from CET1	100	100
Minimum T1	6.0	6.0
Minimum T1 + conservation buffer		8.5
Minimum Total Capital	8.0	8.0
Minimum Total + conservation buffer	8.0	10.5
Ineligible capital instruments	Phased out over 10-year horizon beginning 2013 with recognition capped at 90 per cent in 2013, the caps reducing by 10 per cent each year, ending in 2022 or at first available redemption date.	
Countercyclical capital buffer		If needed, up to an additional 2.5 per cent CET1 from 1 January 2016
Leverage ratio	Supervisory monitoring from 2011; parallel run 2013-2017; disclosure from 2015; migration to Pillar 1 2018.	

* *This is the capped capital conservation buffer amount*