Banking (prudential standard) determinations Nos. 5, 6, 7, 8 and 9 of 2011

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 9 December 2011, APRA made the following determinations (**the instruments**) under subsections 11AF(1) and 11AF(3) of the Act:

1. Banking (prudential standard) determination No. 5 of 2011, which revokes *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (as determined by Banking (prudential standard) determination No. 4 of 2007 and varied by Banking (prudential standard) determination No. 1 of 2011 which took effect on 1 March 2011) (**the existing APS 111**) and determines a new *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (**APS 111**);

2. Banking (prudential standard) determination No. 6 of 2011, which revokes *Prudential Standard APS 116 Capital Adequacy: Market Risk* (as determined by Banking (prudential standard) determination No. 9 of 2007 which took effect on 1 January 2008) (**the existing APS 116**) and determines a new *Prudential Standard APS 116 Capital Adequacy: Market Risk* (**APS 116**);

3. Banking (prudential standard) determination No. 7 of 2011, which revokes *Prudential Standard APS 120 Securitisation* (as determined by Banking (prudential standard) determination No. 4 of 2011 which took effect on 26 October 2011) (**the existing APS 120**) and determines a new *Prudential Standard APS 120 Securitisation* (**APS 120**);

4. Banking (prudential standard) determination No. 9 of 2011, which revokes *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (as determined by Banking (prudential standard) determination No. 5 of 2008 which took effect on 1 January 2009) (**the existing APS 330**) and determines *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (**APS 330**); and

5. Banking (prudential standard) determination No. 8 of 2011, which revokes *Prudential Standard APS 310 Audit and Related Matters* (as determined by Banking (prudential standard) determination No. 4 of 2008 which took effect on 1 January 2009) (**the existing APS 310**) and determines *Prudential Standard APS 310 Audit and Related Matters* (**APS 310**).

The instruments will take effect on 1 January 2012.

1. Background

In 1988 the Basel Committee on Banking Supervision (**BCBS**) introduced the Basel Capital Accord (**Basel I**) which set out an internationally-agreed approach to the calculation of regulatory capital for banking institutions using a risk-based methodology. Basel I was subsequently revised under a suite of measures known as the Basel II framework which consists of three Pillars covering minimum capital requirements (**Pillar 1**), a supervisory review process (**Pillar 2**) and market discipline (**Pillar 3**)[1]. The Basel II framework was implemented in Australia in 2008. Further revision was undertaken following the global financial crisis, resulting in enhancements (**the Basel II enhancements**) announced by the BCBS in July 2009 and June 2010.

Australia is a member of the BCBS and was actively involved in formulating the Basel II enhancements. APRA considers that these enhancements will strengthen the Australian banking system. In July 2009, APRA announced its support for the BCBS's initiatives and its intention to set out proposed prudential requirements in response to these initiatives[2]. APRA also took the opportunity to consider other amendments to these prudential standards to clarify existing provisions and to support the implementation of the Basel II enhancements.

The key elements of the Basel II enhancements include a restatement of the key principles governing the acceptable use of fair values for capital and other prudential purposes in the trading and banking books, notably that valuations must be prudent and reliable. It also contains amendments to the capital framework for market risk by requiring banks to calculate additional capital charges for market risk under stressed conditions. Other elements include amendments to Pillar 1 requirements to strengthen the risk capture of the Basel II framework, in particular by strengthening the minimum capital requirements for certain securitisations, as well as expanded disclosure requirements for securitisations and off-balance sheet exposures. Adopting the Basel II enhancements in Australia involves amending five prudential standards (and corresponding reporting standards) relating to risk assessment, capital measurement and public disclosure requirements.

2. Purpose and operation of the instruments

Banking (prudential standard) determination No. 5 of 2011 (instrument no. 5)

The purpose of instrument no. 5 is to revoke the existing APS 111 and to replace it with a new APS 111 containing requirements relating to the measurement of regulatory capital.

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[1] Pillar 1 sets out minimum capital requirements to address credit, operational and market risk; Pillar 2 provides for supervisory oversight of ADIs' regulatory capital while Pillar 3 seeks to impose market discipline through disclosure requirements.

[2] http://www.apra.gov.au/adi/Documents/cfdocs/Enhancements-to-Basel-II-capital-framework-15-Jul-09-Final.pdf

The main changes to the existing APS 111 relate to asset valuation for capital calculation purposes and in particular to the use of fair values in calculating regulatory capital. Valuation provisions currently included in the existing APS 116 have been moved to APS 111. Further details are included in Attachment A to this Explanatory Statement.

The changes to APS 111 are intended to enhance the measurement of an ADI's financial instruments when the fair value method is used to measure its assets for capital purposes. In particular, these changes aim to capture any fair value gains and losses in illiquid financial instruments.

Banking (prudential standard) determination No. 6 of 2011 **(instrument no. 6)**

The purpose of instrument no. 6 is to revoke the existing APS 116 and replace it with a new APS 116 containing requirements relating to an ADI's market risk framework and associated capital requirements.

The main changes to the existing APS 116 are to supplement the existing methodologies for calculating an ADI's capital requirement for market risk. The key changes primarily supplement the current Value-at-Risk (**VaR**)-based trading book framework with an incremental risk capital charge and a stressed VaR requirement. The changes also make the capital charge for securitised products in the trading book consistent with the treatment of securitised products in the banking book (with some exceptions). Further details are included in Attachment A to this Explanatory Statement.

The changes to APS 116 are intended to better measure market risk in certain securitisation exposures in both the trading book and the banking book in stressed scenarios.

Banking (prudential standard) determination No. 7 of 2011 **(instrument no. 7)**

The purpose of instrument no. 7 is to revoke the existing APS 120 and replace it with a new APS 120 which contains capital adequacy requirements for securitisation.

APS 120 sets out the methodology for the calculation of an ADI's regulatory capital requirement for its securitisation exposures. The key changes introduce several amendments to risk-weights for resecuritisations, use of ratings subject to self-guarantee, operational requirements for credit analysis and changes to credit conversion factors for eligible liquidity facilities. APRA has also taken the opportunity to clarify certain definitions, introduce a new notification requirement and introduce a new capital treatment for certain matters. Further details are included in Attachment A to this Explanatory Statement.

The changes to APS 120 are intended to more appropriately reflect the risk inherent in certain securitisation and resecuritisation exposures.

Banking (prudential standard) determination No. 9 of 2011 **(instrument no. 9)**

The purpose of instrument no. 9 is to revoke and replace the existing APS 330 with a new APS 330 which contains requirements for the public disclosure of certain prudential information on capital adequacy.

APS 330 expands the disclosure requirements to include securitisation exposures within the trading book, and to broadly align these disclosures with securitisation disclosures in the banking book. The existing APS 330 requires the CEO of the ADI to attest to the reliability of the disclosures required under APS 310. However, this requirement does not readily align with the annual declaration requirements in APS 310, which require the Board and CEO to attest to the ADI's risk management systems. This means that ADIs are providing attestations for the purposes of both APS 310 and APS 330. The attestation requirement in the existing APS 330 has therefore been transferred to APS 310.

The changes in APS 330 are intended to clarify existing disclosure provisions and improve the consistency of prudential disclosure requirements with APS 310.

Banking (prudential standard) determination No. 8 of 2011 **(instrument no. 8)**

The purpose of instrument no. 8 is to revoke and replace the existing APS 310 with a new APS 310 to reflect the consequential amendments to APS 310 arising from changes to APS 330.

APS 310 outlines prudential requirements relating to an ADI's internal information control and the requirements for appointing and engaging with external auditors. The existing APS 310 requires the Board and CEO to attest to the ADI's reliability of its risk management systems.

The key change to APS 310 is to include a requirement that the Board and CEO attest to the ADI's compliance with its disclosure obligations under APS 330. This is intended to streamline an ADI's attestation requirements.

3. Consultation

APRA undertook consultation on its proposed adoption of the enhancements of the Basel II framework in Australia between December 2009 and May 2010. Submissions were received from, and discussions held with, numerous ADIs and industry bodies, and other interested parties.

APRA released the following documents between December 2009 and May 2011:

- **December 2009** - Discussion paper, '*Enhancements to the Basel II framework in Australia*'[3], draft prudential standards and draft prudential practice guides;

- **May 2010** - Discussion paper, '*Enhancements to the Basel II framework in Australia: reporting requirements*'[4], draft reporting standards, draft reporting forms and draft reporting instructions;

[3] http://www.apra.gov.au/adi/Pages/proposed-basel-ii-enhancements-2009.aspx

- **October 2010** - A letter relating to the BCBS's adjustments to the document '*Revisions to the Basel II market risk framework*'[5] to reflect additional BCBS amendments to the Basel II enhancements; and
- **May 2011** - Response to submissions paper, '*Enhancements to the Basel II Framework in Australia*'[6], final prudential standards, reporting standards, prudential practice guides and reporting instructions.

APRA has considered the issues raised by industry and other interested parties in the development of the final set of prudential standards. Submissions received by APRA broadly supported the BCBS's approach and APRA's proposed implementation of the Basel II enhancements. Some submissions sought clarifications on various matters set out in the prudential standards. In response to these requests, APRA has modified certain provisions in the prudential standards to improve the clarity of the requirements. Industry feedback was helpful in ensuring that APRA's approach to the adoption of the Basel II enhancements is appropriate to the operations of ADIs.

[4] http://www.apra.gov.au/adi/Pages/enhancements-to-the-basel-ii-framework-in-australia-may-2010.aspx

[5] http://www.apra.gov.au/adi/Documents/cfdocs/Ltr-to-all-ADIs-regarding-mkt-risk-adjustments-7Oct10.pdf

[6] http://www.apra.gov.au/adi/Pages/Enhancements-to-the-Basel-II-Framework-in-Australia.aspx

4. Regulation Impact Statement

Regulation Impact Statement

Basel II enhancements

Proposed enhancements to the Basel II framework in Australia

(OBPR ID: 2010/12052)

Background

This Regulation Impact Statement (RIS) follows the previous related preliminary assessment OBPR ID: 2010/12052 on Basel II enhancements for APRA-regulated institutions which was submitted to OBPR on 19 November 2010. The preliminary assessment detailed APRA's proposed changes to prudential standards relating to capital adequacy, risk management and supervision requirements for authorised deposit-taking institutions (ADIs).

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 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. Under the *Banking Act 1959* (the Banking Act), APRA is empowered to issue binding prudential standards that set out specific requirements to which ADIs must adhere. These standards are supported by prudential practice guides (PPGs) which clarify APRA's expectations with regard to prudential requirements.

APRA regularly reviews its regulatory regime and amends its prudential requirements as a result of a number of factors including:

- international developments;
- changes in financial market conditions or changes in risk management practices;
- in response to identified weaknesses in the prudential framework; and/or
- to reduce potential negative impacts of emerging industry issues.

One of the key components of APRA's prudential framework is the suite of prudential standards which require ADIs to hold regulatory capital as a buffer against the risks which they undertake (capital standards). APRA's capital standards for ADIs follow closely those set by the Basel Committee for Banking Supervision (BCBS). In particular, they implement the two international capital accords released by the BCBS: the 1988 Basel Capital Accord (Basel I) and the 2004 *International Convergence of Capital Measurement and Capital Standards* (Basel II). The capital regime outlined in these accords was always intended to be a 'living framework' and subject to ongoing review. Both Basel I and Basel II were designed to harmonise regulatory capital requirements around the world and to make them more sensitive to risk.

APRA implemented the Basel II framework through prudential standards and PPGs that took effect from 1 January 2008. Basel II introduced more risk-sensitive measures, including requirements to hold capital against other risks, such as operational and interest rate risk. 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 provides for supervisory oversight of ADIs' regulatory capital while Pillar 3 seeks to impose market discipline through disclosure requirements. The Basel II framework also introduced a mechanism through which the more sophisticated ADIs could be authorised to use internal models to assess their risks. These ADIs are referred to as 'advanced ADIs'. For ADIs with a simple business model and a risk profile that can be managed relatively easily, Basel II provides standardised risk measures against which capital must be held. These ADIs are referred to as 'standardised ADIs'.

As part of its strategic response to address weaknesses revealed by the global financial crisis which commenced in mid-2007, and in accordance with the 'living framework' nature of the capital regime, the BCBS reviewed whether its existing requirements should be amended. In July 2009, the BCBS announced the following

amendments to the Basel II framework in three documents, to come into effect from 1 January 2012:

- *Enhancements to the Basel II framework;*
- *Revisions to the Basel II market risk framework; and*
- *Guidelines for computing capital for incremental risk in the trading book*

Collectively, these documents are referred to as 'the Basel II enhancements package'.

The Basel II enhancements package primarily aims to ensure that the risks inherent in ADIs' portfolios related to trading activities, securitisations and exposures to off-balance sheet vehicles are better reflected in minimum capital requirements, risk management practices and accompanying disclosures to the public.

The key proposals of the Basel II enhancements therefore include amendments to the market risk framework, requiring banks to calculate additional capital charges for market risk under stressed conditions. In addition to the trading book proposals, amendments to Pillar 1 are also outlined, focusing on strengthening the minimum capital requirements for certain securitisations. The Basel II enhancements also include amendments to Pillar 3, to strengthen disclosure requirements for securitisations, off-balance sheet exposures and trading activities.

In addition to the amendments outlined for Pillar 1 and Pillar 3, the Basel II enhancements also included supplemental Pillar 2 guidance addressing weaknesses in banks' risk management processes during the global financial crisis. APRA advised Australian ADIs in July 2009 of its expectation that they have regard now to the supplemental Pillar 2 guidance on risk management provided by the BCBS as part of the Basel II enhancements. APRA also indicated that it will be incorporating aspects of this guidance in prudential standards currently under review. As such, the Pillar 2 supplemental guidance is not included in the scope of proposals outlined in this RIS.

Implementing the Basel II enhancements outlined above will involve changes to:

- *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111);
- *Reporting Standard ARS 110.0 Capital Adequacy* (ARS 110.0);
- *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116);
- *Prudential Practice Guide APG 116 Market Risk* (APG 116)
- *Reporting Standard ARS 116.0 Market Risk* (ARS 116.0);
- *Prudential Standard APS 120 Securitisation* (APS 120);
- *Prudential Practice Guide APG 120 Securitisation* (APG 120);

- *Reporting Standard ARS 120.0 Standardised Approach – Securitisation* (ARS 120.0);

- *Reporting Standard ARS 120.1 - Internal Ratings-based (IRB) Approach* (ARS 120.1);

- *Reporting Standard ARS 120.2 - Securitisation - Supplementary Items* (ARS 120.2);

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

In addition, there will be a clarifying change to *Prudential Standard APS 310 Audit and Related Matters* (APS 310) regarding chief executive officer (CEO) sign off on prudential disclosures made under APS 330.

APRA also proposes other amendments to its capital standards to clarify existing provisions and support the implementation of the Basel II enhancements. These include:

- expanding the scope for an additional capital charge for providing implicit support to a securitisation structure;

- introducing a requirement that an ADI not ascribe any value in capital calculations to a positive mark-to-market value for a basis swap;

- provision for APRA to limit an ADI's ability to further securitise exposures or acquire further securitisation exposures;

- expanding the scope of disclosure requirements for securitisation exposures; and

- introducing a requirement for ADIs to include comparative quantitative data in their Pillar 3 disclosures.

Implementing the proposals also requires amendment to APRA's prudential reporting forms to capture information about the changes to the measurement of capital in the market risk reporting framework and changes to the securitisation reporting framework. All of the proposals outlined above are collectively referred to as 'the Basel II enhancements' for the purposes of this RIS. More details about the proposals are included in Attachment A.

As at March 2011, there are 126 locally-incorporated ADIs (including five advanced ADIs) to which the proposed Basel II enhancements are to apply.

Problem

In reviewing the Basel II enhancements package proposed by the BCBS, the issue identified is whether the Basel II enhancements should be implemented in Australia, through amendments to APRA's prudential standards.

In addressing this issue, a key consideration that APRA has taken into account is that the Australian banking system operates in a global financial market and as such, developments in the global economy have a direct impact on domestic ADIs. This is further compounded by the fact that a sizeable proportion of ADIs' funding is sourced offshore. The IMF has estimated that, as at March 2010, approximately 37 per cent of Australian banks' liabilities are made up of foreign deposits, foreign short term and foreign long term funding[7].

The global financial crisis resulted in substantial financial losses and instability in a number of countries. This global instability had an immediate spill over effect on the Australian economy, by way of the freezing of wholesale funding markets due to liquidity issues and credit risk uncertainty. In 2009, Australian banks were able to raise over $60 billion of longer-term wholesale financing only as a result of the Australian Government's guarantee of wholesale funding, which came into effect at the start of December 2008. Notwithstanding the underlying quality of securitisations originated by ADIs in Australia, the Australian securitisation market was not immune from the global loss of confidence in structured credit instruments and the market is only now recovering.

Furthermore, the crisis revealed weaknesses and gaps in APRA's existing prudential capital framework. An important source of losses and build-up of leverage occurred in the trading books of major global banking institutions. The BCBS acknowledged that the current capital framework for market risk, based on the 1996 amendments to Basel I, does not capture some key risks, including default risk as well as migration risk for unsecuritised credit products. Given that APRA's prudential standards for market risk are based on the 1996 amendments to Basel I, APRA also identified that its prudential standard on market risk did not capture some of these key risks.

Another key area of concern was the assessment of risk and capital for securitisation exposures. The crisis has shown that collateralised debt obligations comprised of asset-backed securities (i.e. CDOs of ABS or so-called 'resecuritisations') are more highly correlated with risk than are traditional securitisations. APRA reviewed its prudential standard for securitisation and assessed that the current requirements do not capture the risks associated with these resecuritisation structures.

The BCBS also formed the view that increased disclosure requirements should provide timely, relevant, reliable and useful decision-making information that promotes institutional transparency. APRA also identified that its prudential requirements for disclosure did not cover certain elements relating to an ADI's securitisation exposures.

[7] IMF Working Paper, 'Australian Banking System Resilience: What Should Be Expected Looking Forward? An International Perspective', Pierluigi Bologna, October 2010, reference WP/10/228, page 13.

Therefore, based on APRA's experience as the prudential supervisor during the crisis and analysis of its prudential framework for ADIs, APRA believes that the deficiencies that the Basel II enhancements are seeking to address exist in the Australian prudential framework and present risks that require addressing.

Objectives of APRA's initiative

By adopting the Basel II enhancements in Australia, APRA's objectives are to:

- address deficiencies in the Basel II capital framework highlighted by the global financial crisis with a view to preventing Australian ADIs from faltering in any future crisis; and

- continue to align Australia's capital regime with international minimum requirements.

Options

APRA has identified four options relating to the implementation of the Basel II enhancements:

1. maintain APRA's existing prudential framework; or

2. partially implement the Basel II enhancements; or

3. fully implement the Basel II enhancements; or

4. implement stronger measures than proposed by the Basel II enhancements.

Option 1– maintain APRA's existing prudential framework

Under this option, APRA would not make changes to existing standards to incorporate the Basel II enhancements. The deficiencies identified by the BCBS would instead be addressed through increased supervision and, potentially, by ad hoc adjustments to ADIs' regulatory capital requirements.

Option 2 – partially implement the Basel II enhancements

Under this option, APRA would only implement certain elements of the Basel II enhancements.

Option 3 – fully implement the Basel II enhancements

Under this option, APRA would adopt the Basel II enhancements, inclusive of the additional matters APRA has identified as necessary to give effect to these measures.

Option 4 - implement stronger measures than proposed by the Basel II enhancements

Under this option, APRA would adopt stronger measures than proposed by the BCBS, by further increasing capital requirements.

Impact analysis

Assessment of costs and benefits

APRA specifically invited submissions on the impact of implementing the Basel II enhancements and respondents were invited to use the OBPR's Business Cost Calculator. None of the submissions took up this invitation. The following analysis does not therefore include an accurate determination of quantitative estimates of costs and benefits.

In the absence of data provided by ADIs, it is difficult for APRA to be able to estimate the compliance costs of implementing the Basel II enhancements. Estimating overall compliance costs for the industry is further complicated by the fact that the proposed changes will have varying impacts on ADIs depending on the nature of their operations. Not all ADIs in the industry will be impacted by the proposed changes and ADIs that are impacted will face varying degrees of changes in compliance costs. Due to the complexity of estimating quantitative costs of the proposals, the RIS provides a qualitative description of the types of compliance issues ADIs may face in each of the addressed options.

Option 1 – maintain APRA's existing prudential framework

The potential costs of this option are considered long term and latent as they are not immediately ascertainable. Given the numerous failures overseas as a result of inadequate risk management practices, making no change in existing regulatory standards and leaving this risk unaddressed increases likelihood of poor practices occurring in Australia. In extreme cases, this could lead to institutional failure, as has been evidenced overseas.

Internationally active ADIs would also suffer from a perception that their home country's regulatory regime was less robust when measured against global expectations as set out in the BCBS principles and standards. In any event, international markets and counterparties would hold Australian banks to the international standards and measures. Any suggestion that Australian ADIs are unable to meet higher standards could affect the reputation of the Australian banking system and could increase the cost of overseas wholesale funding which will affect profitability (and, ultimately, consumers).

Foreign bank branches operating in Australia would potentially be at a competitive disadvantage compared to Australian ADIs (whether internationally active or not) as the foreign banks will be subject to the Basel II enhancements in their home jurisdictions.

There could also be additional costs should APRA seek to address the deficiencies addressed in the Basel II enhancements under its existing supervisory processes. That is, APRA could exercise its Pillar 2 discretion and seek to impose additional capital requirements to address the risks otherwise managed through the Basel II enhancements.

Failing to implement the Basel II enhancements would also negatively affect APRA's membership of the BCBS and reputation as a world-class regulator (and, indirectly, Australia's reputation). Potential costs include the reputational damage to APRA – and to the Australian economy – should an ADI falter because it was not required to apply the more stringent Basel II enhancements. There are also potential reputational and legal costs should APRA seek to incorporate the Basel II enhancements through its existing supervisory regime and be unable to do so because there are no binding prudential requirements.

Maintaining APRA's current prudential regime would have little or no direct flow-on effect to depositors. Depositors have the benefit of the Financial Claims Scheme which currently guarantees deposits with individual ADIs of up to $1 million.

Option 2 – partially implement the Basel II enhancements

APRA has assessed that partially implementing the Basel II enhancements would not present any material advantages to ADIs and to APRA, as compared with not implementing the reforms at all, while still potentially increasing compliance costs. This is because all elements of the Basel II enhancements package address weaknesses in the current prudential framework which are interlinked. Failure to implement one element of the package would undermine the effectiveness and the ability of APRA to enforce the other elements of the package. It would also expose ADIs to greater levels of risk in certain activities than their international counterparts. For instance, should ADIs not be required to implement the revised requirements for resecuritisation, such as the due diligence requirements, but be required to implement the more stringent market risk measures, this may indirectly encourage ADIs to pursue more high risk resecuritisation activity.

Option 3 – fully implement the Basel II enhancements

The BCBS's proposals are designed to address deficiencies identified in the global financial crisis. Adopting them would more properly ensure risks are identified and measured, and appropriate regulatory capital is held against them. The Basel II enhancements will therefore provide APRA with information and powers to identify and correct inappropriate risk management practices. Where ADI risk management practices are considered inappropriate, supervisors will be able to require appropriate corrective action from ADIs.

Valuation practices: APS 111 and ARS 110.0

The capital levels of some ADIs may be impacted by the requirement for any fair value gains and losses that do not meet the enhanced requirements for use of fair value to be deducted. This means that some ADIs may have to upgrade their systems to comply with the requirement for daily mark-to-marketing of fair value positions in both the banking and trading books. However, this requirement only applies to those ADIs that account for certain financial instruments at fair value. APRA is aware that this requirement may only affect some of the advanced ADIs and the impact on their capital positions would be minimal, given that the affected ADIs do not fair value a large portion of their financial instruments in the banking book. APRA also

emphasises that the requirements relating to the use of fair value for capital and other prudential purposes do not require ADIs to change their valuation procedures for financial reporting purposes. In fact, ADIs are required to use their valuation procedures for financial reporting purposes in order to satisfy prudential requirements, hence no additional compliance burden is expected from this amendment.

Revision to the market risk framework: APS 116 and ARS 116.0

The enhanced application of risk management tools and practices is expected to supplement institutions' forward-looking approach to Value-at-Risk (VaR), and demonstrate that they recognise the strengths and weaknesses of assumptions within their risk models. The improved rigour of stress testing is intended to allow Boards and risk managers to more appropriately assess risk, including during benign economic conditions. In addition, ADIs should be able to access higher quality capital funding and be better equipped to handle stressed market situations. The costs will be in implementing appropriate compliance measures including incorporating the new Stressed VaR requirements. ADIs will also need to revise their reporting and risk-measurement processes and are likely to incur additional compliance costs associated with revising their reporting systems.

Based on data obtained from the BCBS's international quantitative impact study (QIS) undertaken in January 2010, the average impact of the trading book proposals on the risk-weighted assets for the advanced ADIs was marginal[8].

Changes to the securitisation framework: APS 120 and ARS 120.0, ARS 120.1 and ARS 120.2

The enhancements may overcome some ADIs' sole reliance on the external credit ratings assigned to securitisation exposures by external credit assessment institutions (ECAIs) Although Credit Rating Agencies provide a useful starting point for credit analysis, they are no substitute for full and proper understanding of the underlying risk, especially where ratings for certain assets have a short history or are volatile. The enhancements should ensure that ADIs have in place the necessary quantitative tools, valuation models and stress tests of sufficient sophistication to reliably assess all relevant risks.

In submissions, ADIs anticipated that the existing requirement for self-assessment of compliance with the securitisation provisions would necessitate unnecessary costs. There will also potentially be higher capital requirements to capture the credit risk of complex trading activities and for providing implicit support to securitisation structures, and as a result of higher risk-weights for resecuritisation exposures. These higher requirements will apply only to those ADIs engaged in complex trading activities, providing implicit support and/or with resecuritisation exposures.

The results of the BCBS QIS, however, suggest that the impact of the proposed Basel II enhancements in relation to securitisation is not large for the advanced ADIs. The impact on risk-weighted assets for the advanced ADIs is again expected to be

[8] This data is confidential and cannot be cited for this reason.

marginal. The QIS also suggests that the Basel II enhancement regarding self-guarantees does not impact on Australian ADIs[9].

Borrowers and depositors may be adversely impacted if new requirements were to lead to additional costs that would ultimately be reflected in higher fees, interest spreads or premiums. Some institutions that currently lack a range of appropriate risk modelling tools and practices may need to devote some resources to establishing them.

Disclosure requirements: APS 330

Some ADIs may incur additional compliance costs associated with the expansion of Pillar 3 disclosure requirements for securitisation. This means that ADIs may need to devote additional resources to incorporate the new disclosure requirements. These costs will only affect ADIs engaged in the types of securitisation structures that are included in the expanded disclosure requirements. ADIs will not be required to disclose information that is not relevant to their securitisation activities. APRA expects that these requirements will predominantly impact on the larger ADIs and the implementation costs will not be material.

Option 4 - implement stronger measures than proposed by the Basel II enhancements

APRA believes that the measures proposed by the Basel II enhancements sufficiently address the weaknesses identified in the existing capital standards. By their very nature, the Basel II enhancements are a more stringent application of the current requirements to the respective activities. For instance, the Basel II enhancements supplement the trading book requirements with a stressed VaR requirement as well as adding an incremental risk charge (IRC) for additional risks. Requirements currently governing securitisation are also now expanded to include resecuritisation activity. Disclosures have also been expanded to take into account both qualitative and quantitative information on securitisation and resecuritisations.

APRA needs to maintain a balance between the need for prudential safety and economic efficiency for ADIs. APRA believes that, should it impose tougher measures than those proposed by the Basel II enhancements, these tougher restrictions will further increase the risk-weighted assets and capital levels of ADIs compared to their international counterparts adopting the minimum Basel II enhancement measures. This may therefore affect the competitive position of ADIs in global funding markets and discourage foreign ADI subsidiaries from entering or continuing their business in Australia. APRA therefore does not believe it is appropriate to implement requirements which become economically prohibitive.

Consultation

The BCBS sought public submissions before issuing the final Basel II enhancements package. On 16 January 2009, three consultative documents were released: *Revisions to the Basel II market risk framework*, *Guidelines for computing capital for*

[9] Ibid.

incremental risk in the trading book and *Proposed enhancements to the Basel II framework*. Submissions were to be made on the first two documents by 13 March 2009 and by 17 April 2009 for the latter document.

APRA also sought public submissions on its proposed implementation of the Basel II enhancements as follows:

- 21 December 2009: Consultation package comprised of a discussion paper, draft prudential standards, and draft PPGs. The discussion paper outlined proposed changes to APRA's prudential standards relating to the capital adequacy of ADIs. In addition, APRA proposed other amendments to prudential standards on capital adequacy to clarify existing provisions and support the implementation of the Basel II enhancements. Written submissions were required before 28 February 2010.

- 5 May 2010: Consultation package comprised of a discussion paper, draft reporting standards, draft reporting forms and draft reporting instructions. The discussion paper outlined the proposed changes to APRA's prudential reporting requirements relating to the changes in prudential standards for ADIs that were outlined in the December consultation package. Written submissions were required before 1 June 2010.

- 7 October 2010: APRA wrote to ADIs about the BCBS' adjustments to the document *Revisions to the Basel II market risk framework* (the market risk revisions), announced on 18 June 2010. Comments were invited on the two main adjustments announced by the BCBS: the capital charge for non-correlation trading securitisation positions and a floor for correlation trading securitisation positions. In addition, ADIs were advised of the revised implementation timeline for the implementation for the Basel II enhancements of 31 December 2011. Written submissions were required before 5 November 2010.

Submissions received

APRA received 11 submissions on the proposals. These broadly supported the approach and intention of APRA's proposals but raised several issues and sought a range of clarifications.

One common area of concern was the proposal to extend the requirements for recognition of fair values in the banking book to the trading book (APS 111). The global financial crisis identified an unacceptable degree of regulatory arbitrage between the banking and trading books. APRA is of the view that a consistent approach to both books is appropriate.

The advanced ADIs queried the necessity of adjusting actual profit and loss results following back testing using intra-day trading results. APRA proposes to exercise its national discretion and require back-testing using both hypothetical and cleaned actual profit and loss results, but will not require adjustment of actual profit and loss results.

APRA also responded to ADIs' concerns about the choice of an appropriate historical observation period to calculate stressed VaR and will not mandate a standard period. In keeping with APRA's principles-based regulatory approach, an ADI can determine the period that is most appropriate for its particular circumstance.

The primary concern about APS 120 was the requirement to perform due diligence and conduct self-assessments of all securitisation exposures, including those held in the trading book. Submissions suggested that the penalty for non-compliance – deduction of the exposure from capital – is overly onerous. APRA's view is that proper risk controls, including due diligence, should not be avoided because they are demanding. The due diligence requirements came about because of concerns that global banking institutions had not performed sufficient due diligence on complex issues. Although Australian ADIs were not as exposed to these complex products to the same degree, APRA supports the principle that ADIs should be fully aware of their exposures and that this necessitates due diligence of all relevant risks.

The proposed operational requirements for use of external credit assessments caused concern from larger ADIs. Enhancements to APS 120 will not allow the use of ratings from ECAIs to determine risk-weights of exposures to securitisations for which the ADI is a liquidity facility provider or swap counterparty. In APRA's view, it is the responsibility of an ADI to understand the structure to which it is providing a facility and it is inappropriate to allow use of a rating where this is dependent on the unfunded support provided by the facility.

Some concern was raised about APRA's ability to impose capital penalties if it identifies that an ADI has provided implicit support to a securitisation. APRA's response is that it will not automatically require additional capital but will determine whether this is appropriate on a case-by-case basis.

Other submissions sought clarity about the wording of particular provisions. APRA has taken account of these submissions and made adjustments accordingly. This includes amending fields in the reporting forms under ARS 120.0, ARS 120.1 and ARS 120.2.

The proposed requirement to disclose qualitative information about internal assessments was seen to be too onerous. APRA acknowledges that the proposed disclosure requirements for securitisations within the trading book potentially increase the compliance burden for some ADIs. However, APRA is of the view that these burdens are outweighed by the benefit of allowing market participants to assess the strength of ADIs' balance sheets regarding their securitisation activities. Lack of investor understanding of complex securitisation products was identified as a significant problem during the global financial crisis.

Conclusion and recommended option

The financial crisis has highlighted areas of existing prudential regulation which need improving. Given that Australian ADIs operate within a global banking system,

APRA believes that these areas of weakness need to be addressed and improved. APRA supports the Basel II enhancements on prudential grounds. Adopting the Basel II enhancements will improve the current regulatory capital, risk management, and disclosure requirements while adding clarity to the original intent of existing requirements. This would be a positive outcome for depositors who would be protected by better institutional risk management practices and capital buffers.

Furthermore, the Australian Government, as a member of the Group of Twenty (G-20), is committed to implementing the BCBS requirements and APRA is an active member of the BCBS. It is not realistic for Australia to operate in isolation and to refuse to adopt internationally agreed banking requirements. Failure to do so would send negative messages to overseas markets on which Australian ADIs rely for a significant proportion of their funding. If these ADIs are subject to lower regulatory requirements, it is likely that their funding costs would rise which would be passed on to borrowers and depositors. It is therefore vital that the Australian regulatory framework not only meets minimum international rules but also that weaknesses in the Australian prudential framework be addressed. ADIs cannot simultaneously rely on cross-border funding, and seek to be exempted from some or all of the internationally applicable regulatory reforms.

Further, APRA is of the view that the Basel II enhancements are prudentially sound and that there is a risk of Australian ADIs faltering in any future financial crisis should these measures not be implemented.

APRA therefore supports adopting Option 3.

Implementation and Review

The final standards are intended to commence on 1 January 2012. There requirements will be reflected in harmonised prudential standards, reporting requirements, and practice guides for the ADI industry.

APRA recognises that there may be a case for some limited exemptions from some aspects of the enhanced requirements and/or some transition provisions for some ADIs. These will be assessed on case-by-case basis.

These prudential standards will be reviewed as necessary to ensure they continue to reflect good practice and remain relevant and effective, for both APRA's prudential supervision purposes and for regulated institutions.

Attachment A: The Basel II enhancements

Valuation practices: APS 111 and ARS 110.0

The Basel II enhancements incorporate a restatement of the key principles governing the acceptable use of fair values for capital and other prudential purposes in the trading and banking books. This includes the extension of valuation provisions previously applied for market risk more generally to the use of fair values in the banking and trading books. As part of this process, deductions required to be made from Tier 1 capital were clarified to include any fair value gains and losses that do not meet the enhanced requirements for use of fair value. These amendments are to be incorporated in the forms issued under ARS 110.0.

Revision to the market risk framework: APS 116 and ARS 116.0

The Basel II enhancements propose revisions to the Basel I market risk framework introduced in 1996. These include supplementing the current value-at-risk (VaR) based trading book framework with a stressed VaR requirement, modifying capital calculation rules for securitised and resecuritised exposures in the trading book and setting the standard method charge for equity specific risk at eight per cent regardless of whether or not the portfolio is liquid and well diversified. These changes will be reflected in the relevant reporting forms issued under ARS 116.0.

Advanced ADIs must complete a number of tables related to stress testing, where the ADI has exposure to the relevant underlying market; these are to be incorporated into the relevant forms issued under ARS 116.0. In light of the global financial crisis, during which credit spread risk was a significant contributor to profit and loss volatility, APRA is proposing to modify the suite of stress tests so that it now includes a series of stress scenarios related to credit spread risk. The proposed new series of stress scenarios are in addition to the Basel II enhancements package.

Stress tests should be mutually beneficial with existing risk management models which are based on complex quantitative models using historical data inputs. In particular, stress tests should provide a series of outcomes that can provide insights into the validity of statistical models with a high degree of confidence. Once the fundamental assumptions of a model have been stressed, institutions should determine VaR at any point in time.

APRA also proposes to clarify the obligation to increase the required amount of market risk capital following 10 or more back-testing exceptions within a year.

Changes to the securitisation framework: APS 120 and ARS 120.0, ARS 120.1 and ARS 120.2

The Basel II enhancements incorporate several changes in the treatment of securitisations, including changes to risk-weights for resecuritisations, use of ratings subject to self-guarantee, operational requirements for credit analysis and changes to credit conversion factors for eligible facilities.

Some of these proposals require amendments to the reporting framework for securitisation and have been included in the revised reporting requirements. Specifically, this includes higher risk-weights for resecuritisations and changes to credit conversion factors for eligible facilities where APRA proposes to apply a consistent credit conversion factor for all eligible facilities regardless of term.

APRA also proposes:

- requiring prior notification of innovative funding facilities to ensure compliance with APS 120;
- clarifying the definition of a basis swap;
- expanding the scope for an additional capital charge for providing implicit support;
- requiring an ADI not to ascribe any value in its capital adequacy calculations to any positive mark-to-market value for a basis swap;
- clarifying the maximum amount of capital that can be applied where an ADI elects to treat securitised assets on-balance sheet for capital adequacy purposes;
- clarifying that, for standardised ADIs, cash collateral facilities that meet the APS 120 definition will attract a 100 per cent risk-weight to reflect the fact that it is an exposure to a trust;
- clarifying that a conduit structure can be considered to be a securitisation;
- including a provision allowing APRA to limit an ADI's ability to further securitise exposures or acquire further securitisation exposures; and
- reinforcing APRA's position that APS 120 applies to ADIs selling exposures into warehouses.

These requirements will be incorporated as necessary into the reporting forms issued under ARS 120.0, ARS 120.1 and ARS 120.2.

Disclosure requirements: APS 330

APRA intends incorporating into APS 330 the guiding principle of the Basel II enhancements that ADIs are responsible for conveying their actual risk profile to market participants. APRA also proposes to require ADIs to disclose:

- securitisation exposures within the trading book as well as the banking book;
- the nature of risks inherent in securitised assets, other than credit risk, and to disclose all securitisation activities of the ADI, either on- or off-balance sheet;
- for advanced ADIs, further qualitative information on their internal assessment approach;
- resecuritisation exposures to enable monitoring of changes in the credit and market risk of these exposures; and
- pipeline and warehousing risks of securitisation exposures.

APRA also intends requiring all locally-incorporated ADIs, not only the advanced ADIs, to disclose basic information on their securitisation exposures on a quarterly basis. APRA also proposes to amend APS 330 to reduce double-reporting requirements.

Attestation requirements: APS 310

APS 330 currently requires an ADI's CEO to attest to the reliability of APS 310 disclosures. This requirement does not readily align with the annual declaration requirements in APS 310, which require the Board and CEO to attest to the ADI's risk management systems. APRA intends to delete the attestation requirement in APS 330 and include it in APS 310.