Regulation Impact Statement

Revocation of APS 150 and ARS 150

Proposed revocation of Basel II transition requirements

(OBPR ID: 2011/12366**)**

Background

This Regulation Impact Statement (RIS) follows from OBPR's preliminary assessment of APRA's proposal to revoke *Prudential Standard APS 150 Capital Adequacy: Basel II Transition (Advanced ADIs)* (APS 150). APRA also proposes to revoke the reporting standard accompanying APS 150, *Reporting Standard ARS 150 Capital Adequacy: Basel II Transition (Advanced ADIs)* (ARS 150) and to replace this with a new *Reporting Standard ARS 118.1 Other Off-balance Sheet Exposures* (ARS 118.1).

Prudential Standards

APRA's mandate is to ensure the safety and soundness of prudentially regulated entities so that they can meet their financial promises to depositors within a stable, efficient and competitive financial system. To achieve this, APRA has implemented a multi-layered prudential framework that encompasses licensing, supervision, reporting and enforcement. Under the *Banking Act 1959* (the Banking Act), APRA is empowered to issue binding prudential standards that set out specific requirements to which authorised deposit-taking institutions (ADIs) must adhere. 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). Both accords sought to harmonise regulatory capital requirements around the world on a risk-based basis. This means that the amount of regulatory capital ADIs must hold is based on measurements of the risks faced by ADIs. Basel I focused on credit risk (and, later, market risk) while Basel II introduced measures to assess other risks such as operational and interest rate risk.

APRA implemented the Basel II framework through prudential standards and Prudential Practice Guides (PPGs) that took effect from January 2008. As well as implementing more risk-sensitive measures than were required under the previous framework, APRA adopted the Basel II mechanisms through which the more sophisticated ADIs could be authorised to use internal models to assess their risks as a basis for determining minimum capital requirements. These ADIs are referred to as 'advanced ADIs' because they use more advanced risk methodologies. In Australia, there are five ADIs now authorised to use the advanced approaches to assessing risk. (For ADIs with a simple business model and a risk profile that can be managed relatively easily, Basel II provided standardised risk measures against which capital must be held. These ADIs are referred to as 'standardised ADIs'.)

When implementing the Basel II framework, APRA was concerned that the advanced Basel II approaches to the measurement of risk were significant innovations to the simpler Basel I method. As a result, there was uncertainty attached to the robustness of the risk estimates developed by the advanced ADIs. Further, the combined assets of the five advanced ADIs constitute the majority of banking assets. APRA was concerned that any sudden decreases in the amount of regulatory capital held by these ADIs as a result of the adoption of their more risk-sensitive models could cause uncertainty and instability in the financial system as a whole.

Because of these concerns, APRA implemented transitional arrangements that prevented the advanced ADIs from decreasing their regulatory capital below a minimum limit, determined by reference to the amount of capital that would have applied had the original Basel Accord continued in force. The maximum reduction in capital was set at 10 per cent from the amount determined in accordance with the Basel I framework. This is referred to as the 'Basel I capital floor' and was the key requirement of APS 150. It was always APRA's intention that this minimum floor requirement in APS 150 was to be a transitional requirement and hence would be removed at an appropriate time.

Reporting standards

APRA is 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).

ARS 150 was made through the exercise of APRA's FSCODA powers. Under ARS 150, advanced ADIs are required to continue to report on four reporting standards on a Basel I basis (in addition to reporting similar items under Basel II):

Reporting Standard ARS 110.0 Capital Adequacy made by *Financial Sector (Collection of Data) (reporting standard) determination No. 1 of 2006* (ARS 110.0);

Reporting Standard ARS 112.1 Capital Adequacy- On-Balance Sheet Risk Weighting Schedule made by *Financial Sector (Collection of Data) (reporting standard) determination No. 2 of 2006* (ARS 112.1);

Reporting Standard ARS 112.2 Capital Adequacy- Off-Balance Sheet Business made by *Financial Sector (Collection of Data) (reporting standard) determination No. 3 of 2006 (ARS 112.2);* and

Reporting Standard ARS 113.0 Market Risk made by *Financial Sector (Collection of Data) (reporting standard) determination No. 4 of 2006* (ARS 113.0),

as in force immediately before 1 January 2008 (the Basel I capital reporting standards).

APRA's supervision teams use data from the Basel I capital reporting standards for the purpose of prudential supervision, including assessing advanced ADIs' compliance with APS 150. ARS 150 specifically noted that data from the Basel I capital reporting standards may also be used by the Reserve Bank of Australia and the Australian Bureau of Statistics.

Problem identification

The Australian Government, as a member of the Group of Twenty (G-20), is committed to implementing the capital regime currently proposed by the BCBS, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III). APRA is a member of the BCBS and has actively participated in the formulation of Basel III and is of the view that Basel III should be implemented in Australia on prudential grounds. APRA will consult on this issue later this year.

Basel III was developed in response to deficiencies exposed by the global financial crisis. As participants in the global financial system, Australia and Australian ADIs were not immune from some of the fallout from this crisis and supports the measures proposed to address deficiencies exposed by the crisis. One such measure is to increase the minimum level of the regulatory capital that ADIs are required to hold. APRA intends seeking submissions later in 2011 with a view to increasing this requirement from the current Basel II minimum of 2 per cent core equity Tier 1 (CET1) and 4 per cent Tier 1 capital to 4.5 per cent CET1 and 6 percent Tier 1.

In September 2010, APRA announced its expectation that these minimum capital requirements would be implemented from 1 January 2013. On 15 February 2011, APRA confirmed this intention by letter to each of the advanced ADIs. That letter noted that the advanced ADIs currently meet the higher minimum requirements under the proposed new regime and expected that they would continue to do so before the formal 1 January 2013 implementation date. APRA's letter advised that, because the new minimum amount of regulatory capital would be much higher than applied under

Basel I, there was no longer any need to apply the Basel I capital floor to the current Basel II regime. Accordingly, APRA indicated its intention to revoke APS 150. Submissions to this proposal received from the advanced ADIs supported APRA's proposal.

APRA also contacted the RBA and the ABS about the proposal. The ABS made no submissions. The RBA raised no objection to the proposed revocation of APS 150. However, the RBA advised that data from two of the Basel I capital forms are used in the assessment of Australian financial stability as well as in a number of internal and external publications and is otherwise unobtainable. These include quarterly statistical tables, the semi-annual Financial Stability Review, international statistical reports such as the International Monetary Fund Financial Soundness Indicators, Board papers, chart packs and crisis management reports. Removing the requirement to report these forms would prevent the RBA from continuing to release these reports and meet its international reporting obligations.

APRA's response to the RBA's submission is to retain only those items where the data continue to be relevant. The proposal is to revoke the Basel I capital reporting standards and replace them with a single form, ARF 118.1 which incorporates the following similar items from ARF 110.0 and ARF 112.2 which the RBA wishes to continue receiving consistently on a Basel II basis:

- data on all derivatives (similar to ARF 112.2 Section B);
- data on non-market-related off-balance sheet exposures (similar to ARF 112.2 and to be completed on an IRB approach); and
- on- and off-balance sheet credit risk amounts (similar to ARF 110.0 Section B).

Objectives of APRA's initiatives

APRA's objectives in revoking APS 150 and replacing the Basel I capital reporting standards with a single, streamlined form are to:

- decrease the regulatory burden and costs on advanced ADIs that currently require reporting and capital calculation by reference to an outdated regulatory requirement;

- encourage early implementation of the Basel III framework; and

- ensure continued use by the RBA of specified data in internal and external publications with minimal impact on the advanced ADIs.

Options

Although APS 150 and ARS 150 are separate regulatory instruments made under different legislation, they are closely linked. Thus the reporting requirements in ARS 150 inform the advanced ADIs' calculation of the Basel I capital floor and APRA's assessment of the ADIs' compliance with APS 150. This linkage is reflected in the wording of both standards which each refer to the other. The following options therefore deal with APS 150 and ARS 150 together.

APRA's options are:

Option 1 - revoke APS 150 and ARS 150;

Option 2 - retain APS 150 and ARS 150 (the status quo); or

Option 3 – revoke APS 150 and ARS 150 and replace with alternative standard/s.

Option 1- revoke APS 150 and ARS 150

Under this option, APRA would revoke both standards, the effect of which would be that the five advanced ADIs would no longer be required to calculate or report their capital requirements based on an assessment of their requirements had the Basel I framework remained in place.

Option 2- maintain status quo

Under this option, the advanced ADIs would be required to comply with the Basel I capital floor and reporting requirements.

Option 3 – revoke APS 150 and ARS 150 and replace with alternative standard/s.

Under this option, APRA would revoke APS 150 and replace ARS 150 with a streamlined reporting standard ARS 118.1 to capture similar data from the current Basel I reporting framework.

Impact analysis

The parties affected by the identified options are:

- the five ADIs currently using the advanced approach to calculated their capital requirements, namely, Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia,[1] Westpac Banking Corporation, National Australia Bank Limited and Macquarie Bank Limited;
- the Reserve Bank of Australia; and
- APRA.

Assessment of Costs and Benefits

Option 1- Revoke APS 150 and ARS 150

The key impact of revoking ARS 150 would be beneficial for the advanced ADIs, which will no longer need to expend resources on estimating the amount of capital they would be required to hold had the Basel I framework remained in place. All of the ADIs support revoking the standard. Revoking APS 150 would have little practical effect since ADIs now hold more capital than the Basel I capital floor requires.

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[1] The Bank of Western Australia (trading as BankWest), a subsidiary of the Commonwealth Bank of Australia, is also included.

The RBA has no concerns with APRA revoking APS 150. However, revoking ARS 150 would inhibit the RBA's exercise of its financial stability functions. It would also pose an obstacle to the continued publication of a wide range of reports and the ability of the RBA to meet international reporting obligations.

Other than the administrative costs expended in drafting, consulting and finalising the instrument of revocation, there are no identified costs for APRA in revoking both standards. As stated previously, the Basel I capital floor requirement applying under the current Basel II regime is expected to be superseded by the forthcoming Basel III capital reforms.

Option 2- Maintain status quo

There are no benefits to the ADIs or to APRA in retaining APS 150 and ARS 150. Basel I reporting and capital requirements are no longer prudentially relevant. As stated above, the key costs are to the advanced ADIs which would be required to continue estimating their capital requirements on a Basel I basis.

The RBA would continue to obtain data from the advanced ADIs' Basel I capital forms, albeit retaining current inconsistencies between reports submitted by advanced and standardised ADIs.

Option 3- Revoke and replace APS 150

Under this option, it is only APS 150 that would be replaced. There is no need for the transitional Basel I capital floor given that in practice the ADIs are expected to meet the more conservative Basel III requirements. There would be some costs to the advanced ADIs in complying with the new, albeit streamlined, form (ARF 118.1). However, according to discussions with the ADIs this would be less than the costs of continuing with the ARS 150 requirements. (These costs are unquantified.)

APRA would incur direct costs of developing a new reporting forms and instructions. However, ongoing costs associated with supervision and monitoring of compliance with these requirements would be part of APRA's normal supervisory processes, thereby limiting the costs that APRA would incur through the introduction of the new reporting form.

The RBA would benefit directly from being able to continually access the items reported for the purposes of their publications, and for that data to be consistent with that reported by the standardised ADIs.

Consultation Statement

APRA has actively engaged with ADIs to determine the effects of revocation of APS 150 and ARS 150. This has involved three letters outlining the proposal and a preliminary meeting. As indicated above, the advanced ADIs all support revocation of both standards. Their preference is to dispense altogether with any of the reporting requirements in the Basel I capital forms. However, they have all indicated their preference for the proposal to introduce APS 118.1 over retention of the existing ARS 150.

APRA has also engaged consultation with the RBA as a stakeholder. The RBA have confirmed their request on certain Basel I items to be transferred to the Basel II forms, and for the banks to report data using these items on a Basel II basis.

Conclusion and recommendation

There is no longer any prudential basis for ADIs to meet the Basel I capital floor. As such, there is no sound basis for continuing to require compliance with APS 150. All affected parties agree with this aspect of the proposal.

Data collected in the exercise of its FSCODA powers may be used by external stakeholders such as the RBA. APRA has sought to balance the compliance costs of the advanced ADIs in reporting against an otiose regulatory requirement (Basel I) with the use of some of that data by the RBA in carrying out its financial stability and reporting obligations. In APRA's view, revoking ARS 150 and replacing it with the streamlined ARF 118.1 is the most appropriate option to satisfy all affected parties.

APRA therefore recommends adopting Option 3 – revoking APS 150 and ARS 150 and replacing the latter with the new ARS 118.1

Strategy for Implementation

APRA intends to revoke APS 150 and ARS 150 by 30 June 2011 and to implement ARS 118.1 for the end June 2011 reporting period. This timetable has been discussed with all affected parties.