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Chair

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Mr Jason Lange
Executive Director
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Department of the Prime Minister and Cabinet
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Dear Mr Lange,

CERTIFICATION OF APRA'S NEW PRUDENTIAL STANDARDS: APS 110, APS 112 and APS 113 – ADI CAPITAL ADEQUACY AND CREDIT RISK REQUIREMENTS

I am writing to certify that APRA has followed a similar process to that required under a Regulation Impact Statement (RIS), in relation to the development of:

- *Prudential Standard APS 110 Capital Adequacy (APS 110);*
- *Prudential Standard APS 112 Standardised Approach to Credit Risk (APS 112); and*
- *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (APS 113).*

APRA has addressed all seven RIS questions, as set out in the attachment to this letter.

The release of APS 110, APS 112 and APS 113 completes a long process of consultation and policy development with various stakeholders, lasting over four years. As set out in Attachment A, APRA considered a number of policy options in developing these standards. The policy options can be broadly summarised as (i) no formal changes to existing capital requirements (ii) implement internationally-agreed minimum capital standards (Basel III reforms), and (iii) implement Basel III reforms with adjustments for Australian conditions. APRA also considered a number of adjustments to option (iii) in response to feedback raised by the industry. These are discussed in APRA's June 2019 and December 2020 response papers and APRA's forthcoming November 2021 Response Paper.

Using the regulatory burden measurement framework, APRA estimates that regulated entities will incur additional compliance costs from the implementation of APS 110, APS 112 and APS 113. In aggregate for the ADI industry, APRA estimates these costs at around \$1.5 million

per year, over the next 10 years (see below table).¹ In APRA's view, these costs will be more than offset by the benefits from APRA's reforms, which ensures that the industry maintains an unquestionably strong level of capital in normal times and has the in-built flexibility to weather adverse conditions, absorb losses and continue to provide critical functions to the economy.²

Annual regulatory costs, averaged over 10 years				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$1.5	Nil	Nil	\$1.5

APRA's assessment of the three policy options are summarised in Attachment A of this letter. I am satisfied that the attached report meets best practice consistent with the *Australian Government Guide to Regulation*.

Yours sincerely,



Attachments

Attachment A: APRA Regulation Impact Analysis

Attachment B: APRA Discussion paper: *Revisions to the capital framework for ADIs*, February 2018

Attachment C: APRA Discussion paper: *Improving the transparency comparability and flexibility of the ADI capital framework*, August 2018

Attachment D: APRA Response paper: *Revisions to the Capital Framework for ADIs*, June 2019

Attachment E: APRA Response paper: *A more flexible and resilient capital framework for ADIs*, December 2020

¹ These costs are calculated as the costs which are above the regulatory costs of implementing the Basel III reforms of option (ii). Further details are provided in Attachment A.

² The Financial System Inquiry assessed in 2014 that the costs of an unquestionably strong level of capital would be offset by net economic benefits, and APRA's analysis is that the marginal compliance costs will be low.

ATTACHMENT A: APRA REGULATION IMPACT ANALYSIS

This section sets out APRA's regulatory impact analysis. Consistent with the Australian Government Guide to Regulation, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS). APRA's evaluation of the impact of policy changes to APS 110, APS 112 and APS 113 is provided below.

Background and objectives

Since 2018, APRA has undertaken four rounds of public consultation in revising the issues within APS 110, APS 112 and APS 113 and has engaged with a variety of stakeholders, including APRA-regulated entities, industry bodies, and other regulators.³ This consultation commenced with the release of APRA's February 2018 discussion paper *Revisions to the capital framework for ADIs*, supplemented by an additional discussion paper in August 2018 *Improving the transparency comparability and flexibility of the ADI capital framework*. As detailed in APRA's response papers in June 2019 and December 2020, and this November 2021 responses to submissions, APRA has clarified or amended its proposals in a number of areas, following the consideration of issues raised by stakeholders.

Origins and objectives of the reforms

In its February 2018 discussion paper, APRA set out the problem and why regulatory action was needed. While Australian ADIs have traditionally been well capitalised to withstand the risks they have faced in the past, the Australian Government's 2014 Financial System Inquiry recommended, and the Government subsequently endorsed, that APRA increase capital requirements for ADIs such that they meet 'unquestionably strong' capital benchmarks. APRA also identified a number of concerns that needed to be addressed, including:

- concentration risks in the residential housing market in Australia;
- the alignment of capital and risk under the existing framework;
- ADIs' ability to compete in, and access to, international markets; and
- unnecessary regulatory burden faced by smaller, less complex ADIs.

In addition, as Australia is a member of the Basel Committee on Banking Supervision (Basel Committee), Australia is committed to meeting internationally-agreed standards for prudential regulation for ADIs. The reforms of the Basel framework following the 2008 global financial crisis were strongly endorsed by the G20 (of which Australia is a member), which strongly advocated for full, timely and consistent implementation of the standards.

The two key objectives of action were therefore: (i) implementing the Basel Committee's revised capital framework as appropriate to Australia and (ii) increasing the resilience of the Australian financial sector by building 'unquestionably strong' capital benchmarks for ADIs into the new capital framework. The latter was identified by APRA as a 150 basis points and 50 basis points increase in capital requirements for ADIs on the internal risk-based approach (IRB) to capital and ADIs on the standardised approach, respectively.

³ APRA's consultation on revisions to the ADI capital framework, along with non-confidential industry submissions, can be found here: <https://www.apra.gov.au/revisions-to-capital-framework-for-authorised-deposit-taking-institutions>

In addition to these broader objectives, APRA’s review also set out to make a number of key enhancements to the capital framework. The intended enhancements included:

- **flexibility:** improving the flexibility of the capital framework to make it more responsive to the economic environment (e.g. to support the ability of ADIs to absorb losses and continue lending in stress);
- **risk sensitivity:** increasing the risk sensitivity of the capital framework such that capital is appropriately allocated to risk (e.g. concentration and other risks in the residential housing market);
- **transparency and comparability:** improving the transparency of the ADI capital framework to enable comparisons of capital adequacy across ADIs and international peers such that they are better enabled to compete in and access funding in international markets;
- **competition:** supporting competition by limiting the differences in capital outcomes between ADIs using advanced modelling approaches relative to ADIs utilising the standardised approach; and
- **proportionality:** minimising regulatory burden for smaller ADIs without compromising prudential safety.

Summary of policy options

The February 2018 discussion paper outlined the options available to APRA in reviewing the ADI capital framework, including preliminary analysis on potential industry impacts. The sections below expand on APRA’s initial analysis, taking into account feedback received during the consultation period and the impact of the final standards, APS 110, APS 112 and APS 113. As APRA is committed to meeting internationally-agreed Basel standards for ADIs, the second option is considered the status-quo option.

Option 1: Increase minimum CET1 capital ratios	Increase the minimum common equity tier 1 (CET1) capital ratio for each ADI under APRA’s current capital adequacy framework.
Option 2: Implement Basel III reforms	Modify the current capital adequacy framework through implementing the Basel III reforms relating to credit risk, operational risk, market risk, credit valuation risk and interest rate risk in the banking book.
Option 3: Implement Basel III reforms, adjusted for Australian conditions	Modify the current capital adequacy framework through implementing the Basel III reforms, adjusted to accommodate Australia-specific factors.

Assessment of regulatory costs

As part of the consultation process, APRA invited submissions on additional regulatory costs that could be incurred as a result of the three policy options under consideration. Respondents were invited to use the Australian Government’s Burden Measurement Tool to assess regulatory costs. APRA has considered all relevant compliance and administration costs, including both upfront and ongoing costs, in estimating the regulatory costs of each option.

Option 1: Increase minimum CET1 capital ratios

Under option 1, APRA would raise the minimum CET1 capital ratio requirement applying to ADIs under the current capital adequacy framework to meet the unquestionably strong objective. This would be done through amendments to the minimum ratios set out in APS 110 or by increasing an ADI's prudential capital requirements (PCRs) using the existing power under APS 110. No other changes would be made to the framework.

Under this option, ADIs would revise internal processes and individual management buffers to reflect the new minimum requirements. This would only involve minor implementation costs as the internal processes around capital buffers, policies and reporting have long been established, and only minor changes would be required. This is shown in the following table.

Annual regulatory costs, averaged over 10 years				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	0.01	0	0	0.01

While option 1 would only involve minor implementation costs, most of APRA's key objectives and enhancements would not be met. It would not incorporate the Basel III reforms or more appropriately align capital with risk. For example, capital requirements for higher-risk residential mortgage lending would not be appropriately calibrated to address concentration and other risks in the Australian housing market. This option would also not improve transparency, and it would reduce international comparability, as capital increases made by adjusting ADIs' PCRs would remain confidential and would not be publicly disclosed. In addition, the smaller ADIs could continue to be subject unwarranted regulatory burden under the current framework. Option 1 is therefore likely to produce a net cost.

Option 2: Implement Basel III reforms

Under option 2, APRA would amend the current capital framework to implement the Basel Committee's Basel III reforms. As APRA has already implemented the operational risk capital reforms, and is reviewing the market risk reforms at a later time, this option relates to APRA's reforms to capital adequacy and credit risk capital, applying these revisions to all ADIs as relevant. This option would achieve the objective of implementing the revised international framework, which would meet Australia's G20 commitments, preserve ADIs' continued ability to participate in international markets and improve international comparability.

The Basel III framework introduces new approaches to classifying exposures and sets different risk weights or capital requirements (e.g. replacing internal modelling with supervisory estimates under the IRB approach to credit risk). Implementing such changes would necessitate significant changes to systems and processes. It is expected that the bulk of the regulatory costs would be associated with implementing and maintaining capital models and reporting systems, particularly for larger ADIs who, for the first time, would be required to calculate capital requirements under the standardised approach to credit risk in APS 112. APRA estimates the cost to industry, at an annual average of around \$6.0 million over the next 10 years, as shown in the following table.

Annual regulatory costs, averaged over 10 years				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs

Annual regulatory costs, averaged over 10 years				
Total by sector	6.0	Nil	Nil	6.0

While option 2 is likely to increase Australian ADI reported capital ratios, it would not have delivered the goal of unquestionably strong capital. For example, implementing the Basel III framework for residential mortgages would result in a material reduction in risk weights compared to the current framework, using a segmentation that is not considered suitable for the Australian market. This would not enable the capital framework to be sufficiently risk sensitive to mitigate risks arising from structural concentration. In addition, the Basel III framework is targeted towards large internationally active banks and, in places, is not proportional for small, less complex ADIs who may be impacted by material regulatory burden without clear prudential safety benefits. Option 2 may therefore produce a moderate net benefit.

Option 3: Implement Basel III reforms, adjusted for Australian conditions

Under option 3, APRA would use the Basel III reforms as the starting point, and implement adjustments appropriate for the Australian market. APRA’s objective would still be to deliver ‘unquestionably strong’ capital ratios for ADIs, while balancing several other objectives such as risk sensitivity, competition, transparency and comparability and proportionality.

In general, APRA has calibrated the new capital framework to be moderately more conservative than the Basel III framework, but has also applied adjustments to simplify implementation where possible, using feedback provided by ADIs in submissions. For example, APRA has introduced larger capital buffers, modified asset class segmentations to suit the Australian market (in particular for residential mortgages, the largest asset class), and will implement a capital floor for IRB ADIs from 1 January 2023 instead of allowing a phased implementation. For larger ADIs, APRA has introduced changes to achieve better alignment in certain asset classes between the IRB and standardised approach to ease the burden for ADIs implementing both approaches, and is removing duplication in capital requirements and reporting for New Zealand banking subsidiaries of ADIs. APRA has also developed a simplified capital framework for small, less complex ADIs which is expected to materially reduce burden and enhance efficiency for these ADIs.

As Australia is a member of the G20, it has committed to implementing and applying the Basel III standards at a minimum. Therefore, the regulatory costs arising under option 3 are calculated as those costs which are above the regulatory costs of option 2, which are considered ‘business as usual costs’. APRA’s estimated regulatory costs are below.

Annual regulatory costs, averaged over 10 years				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	1.5	Nil	Nil	1.5

Assessment of net benefits

APRA’s view is that there are strong net benefits of APRA’s approach to choosing option 3 in revising APS 110, APS 112 and APS 113:

- Adjustments are required to the Basel III framework to align capital to risks in the Australian market. Option 3 will allow APRA to mitigate risks arising from the structural concentration of Australian ADIs in residential mortgages, while increasing relative incentives for ADIs to lend to small- and medium-sized enterprises.
- Implementing the Basel III reforms with some transparent adjustments will enable Australian ADI capital ratios to be more easily understood by external stakeholders. Option 3 will reduce the time and effort required by ADIs to produce information to stakeholders to explain the comparability of their capital ratios. In turn, this will support ADIs in competing for funding in international markets.
- The Basel III reforms are targeted at internationally active banks. As option 3 introduces a simplified capital framework for small, less complex ADIs, this will materially lessen regulatory burden for these entities, where appropriate, without compromising prudential safety. As this option introduce measures to limit differences across the capital framework, it will also help drive competition outcomes across ADIs.
- Finally, implementing Basel III reforms with adjustments will allow the capital framework to meet the 'unquestionably strong' capital benchmarks. This will increase the financial strength of ADIs and support the resilience of the Australian financial system. This in turn helps to protect depositors, maintain market confidence and promote financial stability, especially during potential scenarios of financial stress.

Conclusion: comparison of policy options

When developing policy, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, while promoting financial system stability in Australia. APRA considers that, on balance, option 3 will significantly enhance prudential outcomes and improve financial system safety and stability in Australia. As set out below, option 3 is expected to result in a net benefit.

	Option 1	Option 2	Option 3
Regulatory Costs	Low	Moderate	Moderate
Unquestionably strong capital	Meets this criterion	Does not meet this criterion	Meets this criterion
Basel compliance	Does not meet this criterion	Meets this criterion	Meets this criterion
Flexibility	Partly meets criterion	Meets this criterion	Meets this criterion
Risk sensitivity	Does not meet this criterion	Partly meets criterion	Meets this criterion
Competition	Does not meet this criterion	Partly meets criterion	Meets this criterion
Transparency and comparability	Does not meet this criterion	Meets this criterion	Meets this criterion
Proportionality	Does not meet this criterion	Does not meet this criterion	Meets this criterion
Overall	Net cost	Moderate net benefit	Net benefit

Implementation and review

As delegated legislation, prudential standards impose enforceable obligations on APRA-regulated institutions. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a prudential standard, including issuing a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated institution's authority to carry on its business or increasing regulatory capital requirements.

Under APRA's policy development process, reviews of new measures are typically scheduled following implementation. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards, and remain relevant and effective in facilitating sound risk management practices. APRA will also take action within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.