FSI - SEACEN Regional Seminar on Basel III and Capital Management by Banks

Bank Capital: An Australian Perspective

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Agenda

- Regulation and supervision of bank capital in Australia
  - Prudential framework for capital adequacy
  - Supervision framework for capital adequacy
  - Capital instruments used by Australian banks
- Impact of the Basel III capital rules on Australian banks
- Open issues

Prudential framework for capital adequacy

- Prudential Standards
  - APS 110 Capital Adequacy
  - APS 111 Capital Adequacy: Measurement of Capital
  - APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
  - APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*
  - APS 114 Capital Adequacy: Standardised Approach to Operational Risk*
  - APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk*
  - APS 116 Capital Adequacy: Market Risk*
  - APS 118 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*
  - APS 120 Securitisation*
  - APS 330 Capital Adequacy: Public Disclosure of Prudential Information

* Standards associated with Prudential Practice Guides

Capital Management

- Responsibility for capital management rests with each bank
- Board of directors to ensure bank maintains appropriate level and quality of capital commensurate with risks
- Banks must have an Internal Capital Adequacy Assessment Process (**ICAAP**)
- An ICAAP must include (at a minimum):
  - systems and procedures to ensure capital is consistent with risk profile
  - a capital management plan with strategy for maintaining adequate capital and procedures for monitoring regulatory compliance
- ICAAP must be subject to effective and comprehensive review
- Banks must inform APRA of significant departures from their ICAAP

Measurement of Capital Adequacy

- APRA adopts a three-tier approach to capital adequacy measurement:
  - Level 1 (the bank itself or the extended licensed entity)
  - Level 2 (consolidation of the banking and other financial activities)
  - Level 3 (the conglomerate group at the widest level)
- Non-consolidated subsidiaries are excluded from Level 2 but included in Level 3
- Level 1 and Level 2 assessments adopt risk-based framework aligned with Basel II Framework
- Level 3 assessment based on methodology approved by APRA
  - Level 3 policy yet to be finalised - Discussion Paper released in March 2010

Minimum capital adequacy requirements

- Each bank is subject to a prudential capital ratio (**PCR**) determined by APRA
- PCR is, at a minimum, 8% of total risk-weighted assets, half of which must be Tier 1 capital
- APRA may, in writing, require a bank to:
  - maintain a PCR at a specified level above 8%
  - hold more than half of its PCR in Tier 1 capital
  - hold a greater proportion of Fundamental Tier 1 capital than required in APS 111
- Banks subject to Level 3 assessments have to meet minimum group-wide capital requirements approved by APRA (Equity-equivalent (Tier 1 proposal))
- A bank must, as part of its ICAAP, maintain risk-based capital ratios for Tier 1 and total capital above prescribed PCR(s)

Components of Capital Base

- The capital base is the sum of Tier 1 and Tier 2 capital, net of specified deductions and amortisation, subject to limits
- **Tier 1 capital** is made up of **Fundamental Tier 1** and **Residual Tier 1 capital**
- **Fundamental Tier 1 capital** (the highest form of capital):
  - includes, amongst other items, paid-up ordinary shares and retained earnings
  - must constitute at least 75% of net Tier 1 capital
- **Residual Tier 1 capital** (other qualifying Tier 1 capital components):
  - is divided into **Non-innovative and Innovative Residual Tier 1 capital**
  - is limited to 25% of net Tier 1 capital
- **Innovative Tier 1 capital** is limited to 15% of Tier 1 capital
- **Net Tier 1 capital** must constitute at least 50% of a bank's required capital base

Components of Capital Base

- **Tier 2 capital** is made up of:
  - **Upper Tier 2 capital** (components of capital that are essentially permanent)
  - **Lower Tier 2 capital** (components of capital that are not permanent)
- **Tier 2 capital** (net of deductions and amortisation) is limited to a maximum of 100% of net Tier 1 capital
- **Lower Tier 2 capital** (net of deductions and amortisation) is limited to a maximum of 50% of net Tier 1 capital
- **Deductions** are made from Tier 1 capital or 50/50 from Tier 1 and Tier 2 capital

Supervision framework for capital adequacy

- APRA's supervision framework assigns decision-making roles to frontline supervisors and technical specialists
- **Frontline supervisors** are responsible for:
  - analysing statistical returns on capital
  - on-going analysis of adequacy and sustainability of capital for assigned bank(s)
  - setting prescribed PCR(s)
  - approving reductions in capital
  - referring relevant capital matters to technical specialists for advice and/or approval, as required

Supervision framework for capital adequacy

- **Industry Technical Services** is a centralised decision-making unit and is responsible for:
  - ensuring consistency in application of prudential requirements across entities
  - assessing and approving Tier 1 and Tier 2 capital instruments
  - assisting supervisors in making other capital-related decisions
- **Specialist Risk Services** units are responsible for assisting with referrals relating to:
  - all approvals and discretions under APS 113 (**Credit Risk** group)
  - all approvals and discretions under APS 115 (**Operational Risk** group)
  - all approvals and discretions under APS 116 and 117 (**Market Risk** group)

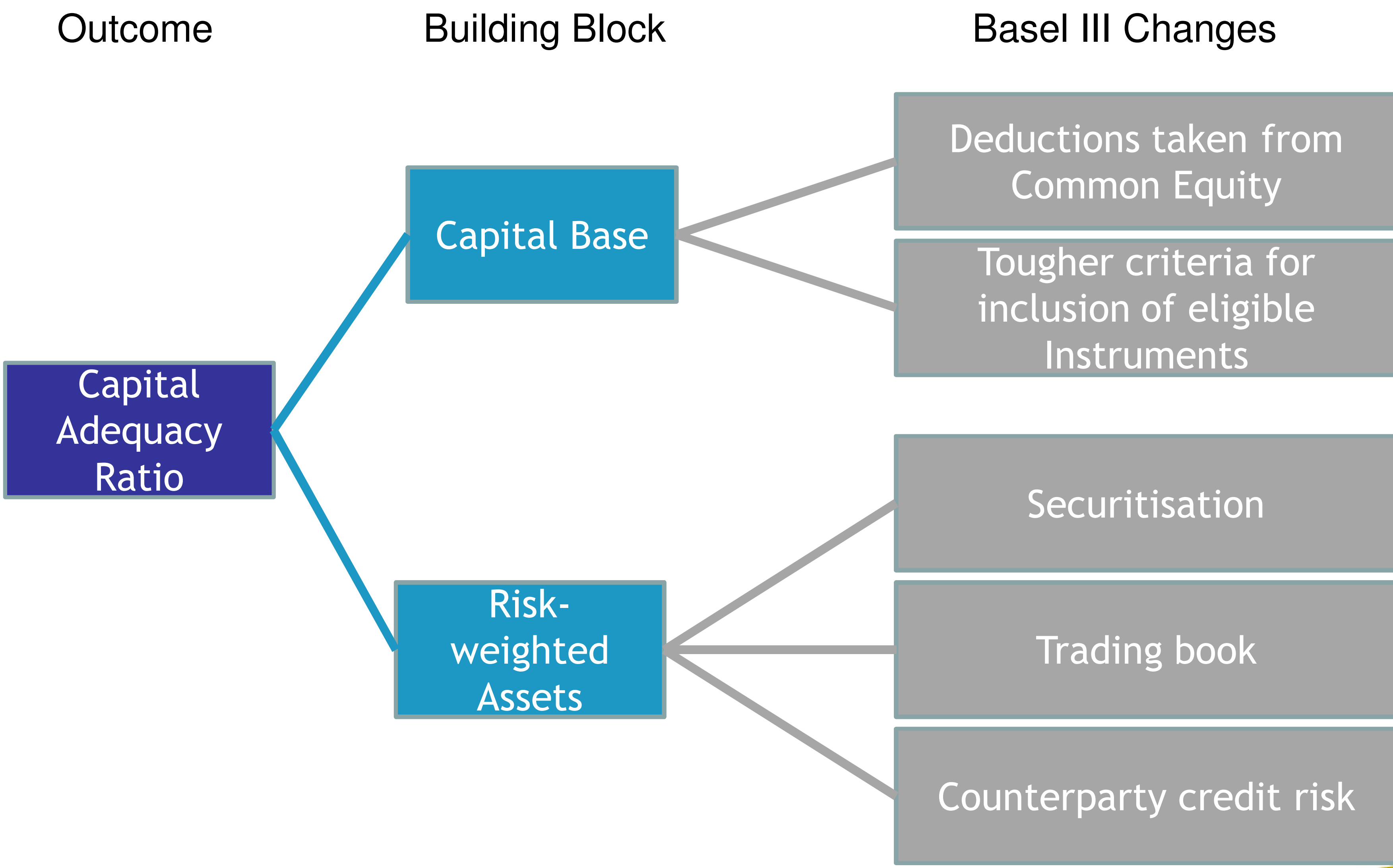
Capital instruments used by Australian banks

- Capital instruments that are issued subsequent to the release of the Basel Committee's December 2009 consultative paper, and that are clearly inconsistent with the proposals are unlikely to be eligible for grandfathering
- Tier 1 capital issuance has generally decreased due to uncertainty about long-term eligibility
- Current **Non-innovative Residual Tier 1** structures include**:**
  - Perpetual non-cumulative preference shares
  - Convertible preference shares
  - Stapled securities (issued only by major banks)

Capital instruments used by Australian banks

- Current **Innovative Residual Tier 1** structures include:
  - Perpetual notes, with step-up, satisfying Tier 1 criteria
  - Convertible perpetual notes with no step-up
  - Preference shares and stapled securities issued through SPVs
- Current **Upper Tier 2 capital** structures include perpetual cumulative (convertible) notes/bonds and perpetual subordinated loans
- Current **Lower Tier 2 capital** structures include term subordinated debt (10-year term with step-up post five years, issuer redemption option at end of year five (subject to APRA's approval))

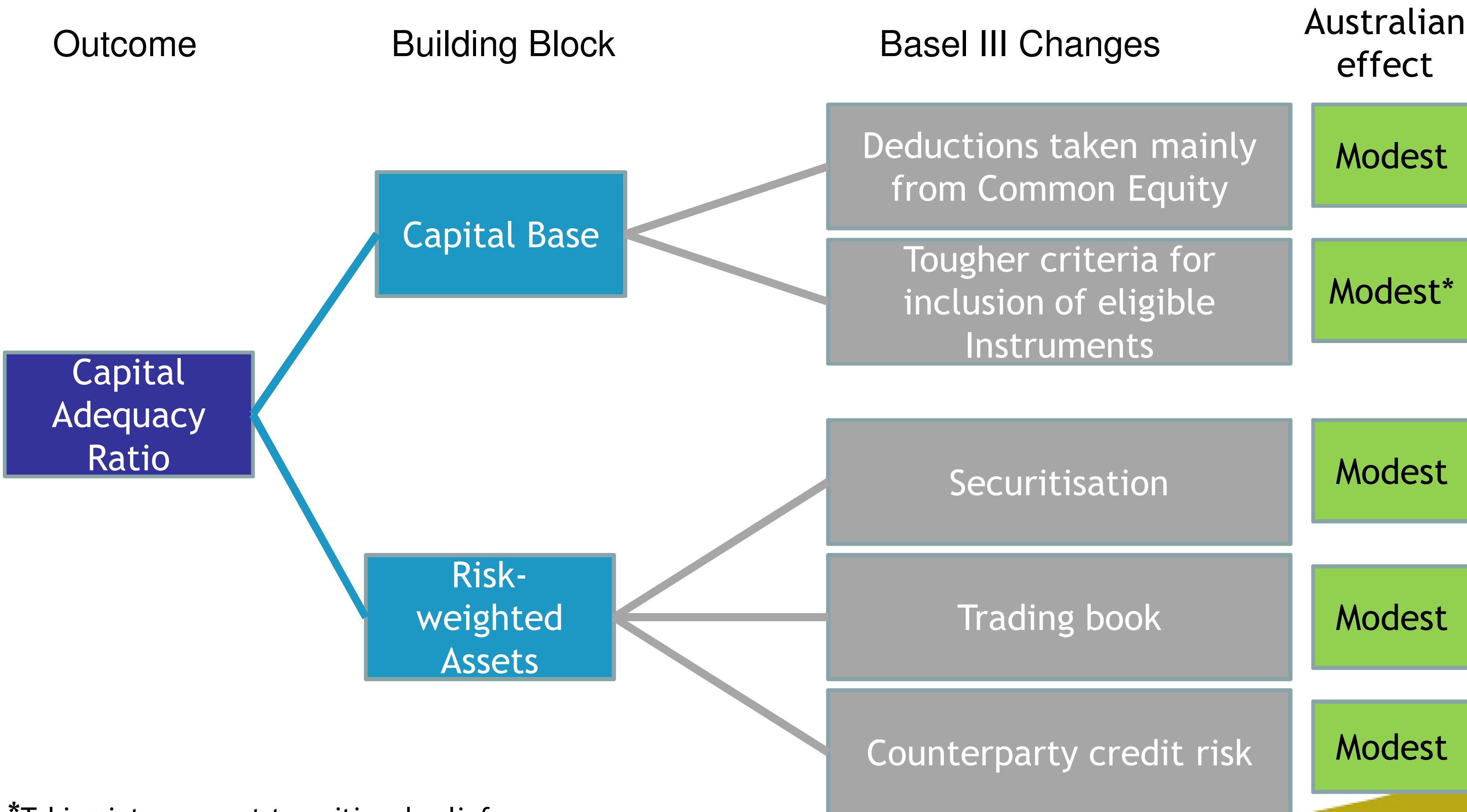
Impact of Basel III capital rules on Australian banks



Impact of Basel III capital rules on Australian banks - QIS

- Five Australian banks participated in the international QIS in 2010
- The QIS indicates that Australian participants are well placed to meet the new capital requirements
  - Deductions taken from common equity - relatively small impact on Australian banks due to APRA's strict current capital requirements
  - Tougher criteria for inclusion of eligible instruments – the majority of Residual Tier 1 and Tier 2 capital instruments issued by Australian participants will become ineligible under Basel III, but will be subject to transitional relief
  - Enhancements to risk coverage (Securitisation, Trading book and Counterparty credit risk changes) - low impact on Australian participants due to their limited involvement in higher-risk trading activities

Impact of Basel III capital rules on Australian banks - QIS



*Taking into account transitional relief

Open issues

- APRA's current requirements are more onerous than Basel III in certain areas, such as:
  - the recognition of certain additional reserves
  - the treatment of deferred tax assets
  - the treatment of equity interests in non-consolidated financial institutions

  APRA is currently considering, as part of its policy development process, whether there are valid reasons to change prudential policy in these areas

- Length of the transition period for ineligible capital instruments and capital buffers

Questions

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