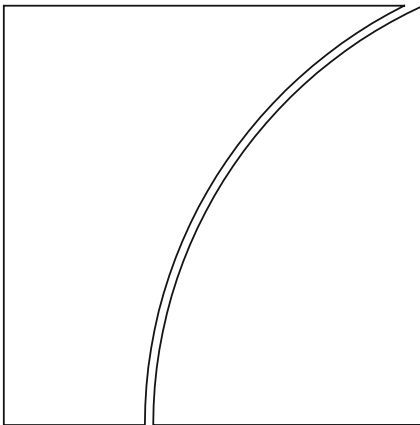


Basel Committee on Banking Supervision



Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III regulations – Australia

March 2014



BANK FOR INTERNATIONAL SETTLEMENTS

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ISBN 978-92-9131-000-5 (print)

ISBN 978-92-9197-133-0 (online)

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Glossary

ABCP	Asset-backed commercial paper
ADI	Authorised deposit-taking institution
AFS	Available for sale
AMA	Advanced Measurement Approaches
APG	ADI Prudential Practice Guide
APS	ADI Prudential Standard
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AT1	Additional Tier 1
Banking Act	Banking Act 1959
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CAR	Capital adequacy ratio
CCF	Credit conversion factor
CCoB	Capital conservation buffer
CCP	Central counterparty
CCR	Counterparty credit risk
CET1	Common Equity Tier 1
CFR	Council of Financial Regulators
CMG	Capital Monitoring Group
CPS	Cross-industry Prudential Standard
CRM	Credit risk mitigation
D-SIB	Domestic systemically important bank
ECAI	External credit assessment institution
EDF	Expected default frequency
EL	Expected loss
FAQ	Frequently-asked question
FSAP	Financial Sector Assessment Program
FSCODA	Financial Sector Collection of Data Act 2001
G-SIB	Global systemically important bank
HLA	Higher loss absorbency
IAA	Internal Assessment Approach
IMM	Internal Model Method
IRB	Internal Ratings-Based
IRC	Incremental Risk Charge
LGD	Loss-given-default
NOHC	Non-operating holding company
PAIRS	Probability and Impact Rating System
PCR	Prudential capital requirement
PD	Probability of default
PONV	Point of non-viability
PPGs	Prudential Practice Guides
PSE	Public sector entity
QIS	Quantitative Impact Study
RBA	Ratings-Based Approach
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted assets
SA	Standardised Approach
SIG	Supervision and Implementation Group
SM	Standardised Method
SOARS	Supervisory Oversight and Response System
T2	Tier 2

Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of the regulatory standards underpinning the Basel Framework. The benefits of the agreed global reforms can only accrue if these standards are incorporated in the member countries' regulatory frameworks and applied appropriately. In 2011, the Basel Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess, and evaluate its members' implementation of the Basel Framework. The assessments under the RCAP aim to ensure that each member jurisdiction adopts the Basel Framework in a manner consistent with the Framework's letter and spirit. The intention is that prudential requirements based on a sound and transparent set of regulations will help strengthen the international banking system, improve market confidence in regulatory ratios, and ensure a level playing field.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel risk-based capital standards in Australia and their consistency with the Basel Committee standards.¹ The team was led by Prof. dr. Paul Hilbers, from the Netherlands Bank (DNB), and comprised five technical experts. The assessment begun in mid-2013 and used information available until 10 January 2014. The counterparty for the assessment was the Australian Prudential Regulation Authority (APRA), which completed the adoption of Basel III risk-based capital regulations in November 2012 (Prudential Standards) and brought them into force on 1 January 2013.

The assessment work consisted of three phases: (i) self-assessment by APRA; (ii) an off- and on-site assessment phase; and (iii) a post-assessment review phase. The off and on-site phase included a visit to Sydney during which the Assessment Team held discussions with APRA, five internationally active Australian authorised deposit-taking institutions (ADIs), two audit firms and one credit rating agency. These discussions provided the Assessment Team with a comprehensive overview and a deeper understanding of the implementation of the Basel risk-based capital standards in Australia. The third phase consisted of a technical review of the findings of the Assessment Team by a separate RCAP Review Team and the RCAP Peer Review Board. This is a key instrument for a substantive quality control mechanism to ensure the consistency of the assessment. The work of the Assessment Team and its interactions with APRA were coordinated by the Basel Committee Secretariat.

The scope of the assessment was limited to the consistency and completeness of domestic regulations in Australia with the Basel Framework. Issues relating to the functioning of the regulatory framework and prudential outcomes were not part of the assessment exercise. Where domestic regulations and provisions were identified to be inconsistent with the Basel Framework, those deviations were evaluated for their current and potential impact on the capital ratios and the international level playing field for ADIs. The Assessment Team did not evaluate the capital levels of individual ADIs, the adequacy of loan classification practices, or the way ADIs currently calculate risk-weighted assets and regulatory capital ratios. As such, the assessment does not cover the overall soundness and stability of the banking sector in Australia, nor APRA's supervisory effectiveness.

The RCAP Assessment Team sincerely thanks APRA Chairman Dr John Laker, Deputy Chairman Mr Ian Laughlin, APRA Member Ms Helen Rowell and the staff of APRA for the professional and efficient cooperation extended to the team throughout the assessment.

¹ It should be noted that Australia's compliance with other Basel III standards, namely the leverage ratio, the liquidity ratios and the framework for systemically important banks (G/D-SIBs) will be assessed at a later date once those standards become effective as per the internationally agreed phase-in arrangements.

Executive summary

APRA completed the adoption of the Basel III risk-based capital regulations in November 2012 (Prudential Standards) and brought them into force on 1 January 2013.

In Australia, Prudential Standards apply to all locally incorporated ADIs,² including small and medium-sized commercial banking institutions that are not internationally active.

The Assessment Team finds the Australian prudential regulation to be **compliant** with the Basel Framework. Twelve of the 14 components assessed are graded as compliant; while two components (definition of capital and the Internal Ratings-based (IRB) approach for credit risk) are regarded as being largely compliant.

The Assessment Team notes the more rigorous implementation of the Basel Framework in certain aspects, for example, related to the definition and measurement of capital. APRA has also implemented some aspects of the Basel III Framework ahead of the internationally agreed timeline and decided not to apply the possibility of an extended transition period in the implementation of the Basel Framework. These elements, however, are not taken into account for the assessment of compliance under the RCAP methodology.

In the definition of capital component, APRA has generally implemented the definition of capital in line with the Basel Framework and has chosen not to permit the use of the threshold deduction treatment (basket), which represents a substantial increase in conservatism within its implementation of the Basel III definition of capital rules. Nonetheless, there are some areas of divergence in APRA's approach relative to the Basel framework.

One material difference that contributes to the largely compliant grading for the definition of capital component is APRA's treatment of investments in an ADI's own capital. In particular, APRA allows certain exemptions to the Basel-required deduction for investments in own-capital instruments that might be interpreted fairly widely by institutions. In APRA's view, however, the exemptions do not constitute indirect holdings as contemplated by the Basel Framework because an ADI will not incur any loss as a result of a change in the value of the capital instruments involved, and because these holdings represent a contribution of genuine capital to an ADI. The Assessment Team, nevertheless, disagrees with APRA because, in the assessors' view, the Basel III definition of indirect holdings was meant only to capture investments in index securities or similar structures, not for what APRA has stipulated.

Another material finding relates to the Basel III requirements for non-viability contingent capital instruments. APRA's Prudential Standard does not guarantee that the issuance of any new shares would occur prior to any public sector injection of capital, and instead relies on APRA's ability to trigger conversion prior to such an injection. APRA notes that this approach was deliberately intended so as not to create moral hazard by using language suggesting that such support may be forthcoming for any ADI. The Assessment Team deems that the materiality of this finding will increase over time as this feature is included in all Additional Tier 1 and Tier 2 instruments going forward (per the Basel III requirements).

The structure and detailed requirements of the internal ratings-based approach for credit risk are largely compliant with the Basel Framework. There are some areas where APRA's IRB Prudential Standard deviates from the Basel Framework. One potentially-material deviation relates to the definition

² Specifically, ADIs include locally incorporated banks (domestically owned and subsidiaries of overseas banks), branches of overseas banks, credit unions, building societies, providers of purchased payment facilities and specialist credit card providers.

of retail exposures where one criterion (specifically, the owner-occupancy status) for retail eligibility in respect of residential mortgage loans was not included. The other deviation, which is deemed material, is the non-application of the 1.06 scaling factor, as prescribed for risk-weighted asset amounts calculated under the IRB approach, to the specialised lending asset class.

The other components of the Basel framework are assessed as compliant, with only some non-material or non-significant differences.

During the RCAP review, the Assessment Team noted some minor items in APRA's prudential standards that, while differing from the Basel standards, have in most cases no material effect. APRA has indicated its intent to correct these oversights (see Annex 6).

Response from APRA

APRA thanks Prof. dr. Paul Hilbers and the Assessment Team for the professional and thorough manner in which the RCAP review of Australia was undertaken.

The Assessment Team finds that Australia's prudential regime is compliant with the Basel Framework. In APRA's view, this is an appropriate rating. The simple reality is that, because of APRA's conservative approach, an internationally active ADI in Australia can face a capital requirement that is at least 100 basis points higher than that facing any other international bank subject to the minimum requirements of the Basel Framework.

The Assessment Team has graded two of the 14 components of the Basel Framework as largely compliant. The first is the definition of capital, where the Assessment Team has drawn attention to APRA's treatment of investments in own capital and in other financial institutions. APRA endorses the fundamental principle of the Basel Framework that regulatory capital should not be double counted or artificially created. Basel III explicitly states that this principle captures indirect funding and holdings of ADIs' own capital and that of other financial institutions. The Framework defines indirect holdings by reference to economic effect — namely, as an indirect exposure where any loss in value results in a loss (to the ADI) that is substantially equivalent to the loss that would arise should the exposure be held directly. APRA has followed this rationale. The relevant exposures are not indirect holdings as the ADI will not incur any loss as a result of a change in the value of the capital instruments involved; rather, the holdings represent a genuine contribution of capital. The Basel Committee's FAQ process will hopefully clarify whether the deviations in this area, and certain others identified by the Assessment Team, represent sub-equivalence.

APRA acknowledges that the Basel requirement for non-CET1 capital instruments to convert, and for new shares to be issued, prior to any public sector support of a troubled institution, has not been replicated *verbatim*. This was done deliberately, and within the spirit of the Basel Framework. Public sector capital support for a banking institution is virtually unprecedented in Australia, and APRA does not wish to create moral hazard by using language suggesting that such support may be forthcoming for any ADI.

The second component where Australia has been assessed as largely compliant relates to the internal ratings-based approach for credit risk. In particular, the Assessment Team has rated APRA's approach to residential mortgage exposures eligible for retail treatment under the IRB approach as a potentially material deviation, as APRA does not include an owner-occupancy constraint. A literal interpretation of the relevant paragraph in the Basel Framework can exclude non-owner occupied exposures. In APRA's view, however, the paragraph is ambiguous and a large number of other Basel Committee member jurisdictions have implemented the relevant paragraph in the same manner as APRA.

1 Assessment context and main findings

1.1 Context

Status of implementation

APRA is the prudential regulator of the financial services sector in Australia. In September 2012, APRA published a final set of Prudential Standards and Reporting Standards that gave effect to major elements of the Basel III capital reforms in Australia. Subsequently, in November 2012, APRA issued a package of final measures, including requirements for counterparty credit risk, which completed APRA's implementation of the Basel III capital reforms (the *Prudential Standards*) for ADIs.³

Prudential Standards apply to all ADIs in Australia, including small and medium-sized commercial banking institutions that are not internationally active, although for the smallest domestic institutions, the implementation is applied with proportionality to take into account the size and nature of their activities. Foreign ADIs (ie foreign bank branches) that are subject to comparable capital adequacy standards in their home country are exempt from the Prudential Standards relating to capital adequacy.

APRA implemented Basel II from 1 January 2008, Basel 2.5 from 1 January 2012 and the Basel III capital requirements from 1 January 2013. The new Pillar 3 disclosure rules came into effect on 30 June 2013. A Prudential Standard on risk management (CPS 220) is scheduled to commence on 1 January 2015.⁴

Implementation context

Structure of the banking system and financial soundness

In March 2013, there were 165 ADIs in Australia with total assets amounting to approximately AUD 4.2 trillion (see also Annex 8). This corresponds to approximately 280% of the gross domestic product. The financial system is dominated by four ADIs, which hold over 80% of total banking assets.

No Australian banks are classified as global systemically important (ie none have been identified as a G-SIB); the four largest ADIs have been classified as domestic systemically important banks (D-SIBs).

Basel standards

The following table provides an overview of the status of adoption of the Basel advanced approaches by Australian ADIs.

³ APRA's Prudential and Reporting Standards are available online on APRA's external website at www.apra.gov.au/adi/PrudentialFramework/Pages/prudential-standards-and-guidance-notes-for-adis.aspx and www.apra.gov.au/adi/ReportingFramework/Pages/ADI-Reporting.aspx.

⁴ A copy of the consultation draft of CPS 220 is at: [www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Draft-Prudential-Standard-CPS-220-Risk-Management-\(May-2013\).pdf](http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Draft-Prudential-Standard-CPS-220-Risk-Management-(May-2013).pdf). As a legislative instrument, it must be tabled in the Australian Parliament and may be disallowed within 15 sitting days by notice of motion by a Member of Parliament.

Status of approval of Basel's advanced approaches

Number of ADIs, end-March 2013

Table 1

	Advanced approach approved by APRA	Application submitted and under review by APRA	Pre-application phase (bank is in process of developing models for APRA approval)	Intent to start pre-application phase
Credit risk (IRB)	5	1	2	0
Market risk (IMA)	5	0	0	0
Operational risk (AMA)	5	1	2	0

Source: APRA.

Certain approaches of the Basel Framework under the internal ratings-based approach for credit risk, the more advanced approaches for counterparty credit risk and the basic indicator approach for operational risk have not been made available by APRA. Other approaches have in some cases been simplified (see also Annex 11).

Regulatory system and model of supervision

Australia has a functional model of financial supervision in which the prudential oversight of all ADIs, insurers and large superannuation funds rests with APRA. The Australian Securities and Investments Commission (ASIC) is responsible for market and corporate conduct, including consumer protection. The Reserve Bank of Australia has responsibility for overseeing financial system stability and the payments system. Coordination takes place through the Council of Financial Regulators (CFR).

APRA was established under the *Australian Prudential Regulation Authority Act 1998* on 1 July 1998 and is responsible for authorising and supervising ADIs. APRA is solely responsible for implementing Basel II, 2.5 and III in Australia. It derives its legal authority to formulate and amend Prudential Standards from the *Banking Act (1959)* (Banking Act).

Structure of prudential regulations

The relevant hierarchy of prudential regulations through which APRA implemented the Basel Framework in Australia consists of the following levels:

- (i) Prudential Standards made under the Banking Act;
- (ii) Reporting Standards made under the *Financial Sector (Collection of Data) Act 2001* (FSCODA);
- (iii) Prudential Practice Guides (PPGs) and other guidance;⁵ and
- (iv) Letters to industry.

Prudential Standards and Reporting Standards are legislative instruments and have the force of law.

The Prudential Standards are supplemented by PPGs, other guidance and letters to industry that provide non-enforceable, non-binding guidance on certain prudential matters. Non-adherence to

⁵ Copies of APRA's PPGs and other guidance are available at: www.apra.gov.au/adi/PrudentialFramework/Pages/authorised-deposit-taking-institutions-ppgs.aspx.

guidance is not a formal breach of the Prudential Standards. Notwithstanding, depending upon the nature and extent of non-adherence, supervisors may take this into account through APRA's Probability and Impact Ratings System (PAIRS) and Supervisory Oversight and Response System (SOARS) supervisory tools in determining an appropriate response, which may include an increase in the regulatory capital requirement or revocation of approval to use a particular methodology.

The internal supervisory processes and procedures under the supervision framework through which APRA supervises the compliance of ADIs with standards, PPGs and letters, include PAIRS and SOARS.⁶

Enforceability and binding nature of prudential regulations

As a general principle, RCAP assessments only take into consideration "binding" regulatory documents that implement the Basel Framework. This is to ensure that the Basel requirements are set out in a robust manner and that a formal basis exists for supervisors and third parties to ensure compliance with the minimum requirements.

The Assessment Team examined the binding nature of various prudential documents issued by APRA using the criteria being applied in RCAP assessments (see Annex 7). Based on the assessment of these seven criteria, the Assessment Team concluded that the Prudential and Reporting Standards, which are legally binding, as well as the PPGs issued by APRA, which give further clarification to the Standards, meet the criteria and hence are eligible for the RCAP assessment. During meetings between the Assessment Team and ADIs and audit firms in Australia, it was evident that PPGs are considered by all market participants to be as fully applicable as Prudential Standards. On that basis, the assessment team concluded that PPGs can be considered within the context of the RCAP assessment.

Areas where APRA rules are stricter than the Basel requirements

In a number of areas, the Australian regulations go beyond the minimum Basel requirements (see Annex 10 for a listing of such requirements). For example, APRA has exercised the discretion provided under the Framework relating to the definition and measurement of capital, which has resulted in a more conservative outcome. APRA has also implemented some aspects of the Basel III Framework ahead of the agreed timeline and decided not to apply the possibility of an extended transition period in the implementation of the Basel Framework because ADIs in Australia were considered by APRA to be well placed to meet the new measures ahead of time. Although these elements provide for a more rigorous implementation of the Basel Framework in some aspects, they are not taken into account for the assessment of compliance under the RCAP methodology.

The last assessment of APRA's compliance with the *Core principles for effective banking supervision* was carried out during 2012 as part of the IMF-World Bank Financial Sector Assessment Program (FSAP), the results of which were published in 2012.⁷ That assessment found that the Australian financial regulatory and supervisory framework exhibits a high degree of compliance with international standards, with an application of Basel II with higher risk weights and a more conservative definition of risk-absorbing capital.

⁶ Information about APRA's supervisory framework is available at: www.apra.gov.au/AboutAPRA/FOI/Pages/Information-Publication-Scheme.aspx.

⁷ The FSAP report of Australia is available at: www.imf.org/external/pubs/ft/scr/2012/cr12308.pdf.

1.2 Scope of the assessment

Scope

The RCAP Assessment Team has considered all documents that effectively implement the Basel Framework in Australia as of 10 January 2014, the cut-off date for the assessment (Annex 4).

The assessment focused on two dimensions:

- A comparison of domestic regulations with the capital requirements under the Basel Framework to ascertain if all the required provisions have been adopted (*completeness* of the regulation); and
- Whether there are any differences in substance between the domestic regulations and the Basel Framework and their significance (*consistency* of the regulation).

The assessment did not evaluate the adequacy of capital or resilience of the banking system in Australia, or APRA's supervisory effectiveness.

Any identified deviations were assessed for their materiality (current and potential) by using both quantitative and qualitative information. For potential materiality, in addition to the available data, the assessment used expert judgment on whether the domestic regulations met the Basel Framework in substance and spirit.

As indicated above, APRA has not made available certain options or approaches. As these approaches are not explicitly mandated by the Basel Framework, the Assessment Team considered them as "not applicable" for the assessment (see also Annex 11).

Bank coverage

For the assessment of materiality of identified deviations, APRA provided data from ADIs on a best efforts basis.⁸ The coverage of ADIs consisted of five internationally active ADIs. No other Australian ADI engages in international banking, other than raising some funds from international money markets.

	March 2013 (AUD billions)	Percentage in terms of AU GDP (Year to March 2013)
Total assets of all ADIs	4,225	282%
Total of five internationally active ADIs	3,564	238%
Market share of five internationally active ADIs	84%	
Total assets of next largest ADI	60	4%
Total assets of largest foreign subsidiary	53	4%

Note: Including off-balance sheet assets.

Source: APRA and www.dfat.gov.au/geo/fs/aust.pdf.

⁸ Data of the following banks were collected (alphabetically): Australia and New Zealand Banking Group Limited (ANZ); Commonwealth Bank of Australia (CBA); Macquarie Bank Limited; National Australia Bank Limited (NAB); Westpac Banking Corporation.

Together, the four largest domestic ADIs dominate the retail and commercial banking markets, accounting for over 80% of banking assets. With the exception of Macquarie Bank Limited, other Australian ADIs engage in international banking operations mainly for funding activities. There are also a number of foreign-owned banks operating in Australia, the largest of which represents 1.4% of total banking assets.

1.3 Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the 15 key components of the Basel Framework and for the overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.⁹ A regulatory framework is considered:

- *Compliant* with the Basel Framework if all minimum provisions of the international framework have been satisfied and if no material differences have been identified that would give rise to prudential concerns or provide a competitive advantage to internationally active banks;
- *Largely compliant* with the Basel Framework if only minor provisions of the international framework have not been satisfied and if only differences that have a limited impact on financial stability or the international level playing field have been identified;
- *Materially non-compliant* with the Basel Framework if key provisions of the framework have not been satisfied or if differences that could materially impact financial stability or the international level playing field have been identified; and
- *Non-compliant* with the Basel Framework if the regulation has not been adopted or if differences that could severely impact financial stability or the international level playing field have been identified.

The materiality of the deviations was assessed in terms of their current or, where applicable, the potential future impact on capital ratios of the ADIs. The quantification was, however, limited to the agreed population of internationally active ADIs. Wherever relevant and feasible, the Assessment Team, together with APRA, attempted to quantify the impact, both in terms of current materiality and potential future materiality based on data collected from Australian ADIs in the agreed sample. The impact on the capital ratios of ADIs was not assessed from the perspective of its possible implications for the wider Australian economy. The assessment did not extend neither to broader systemic risk and financial stability concerns.¹⁰

The non-quantifiable gaps were discussed with APRA and outcomes were guided by expert judgment.¹¹ It was also taken into account that, as a general principle, the burden of proof lies with the assessed jurisdiction to show that a finding is not material or not potentially material.

⁹ This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of Basel III that are not relevant to an individual jurisdiction may be assessed as not applicable (N/A).

¹⁰ Due consideration was given to the number of ADIs having the relevant exposure, the size of exposures impacted, the range of impact and possibility of any rise in the relative proportion of the impacted exposures in the balance sheets of ADIs in the foreseeable future.

¹¹ This same approach has been followed to assess the materiality of differences for the standardised approaches, since the Australian ADIs in the sample use the advanced approaches. Evidence based on the partial-use exposure of ADIs in the RCAP sample has also been taken into account. In establishing the gradings for the standardised approaches, the team, in line with

Further information on the materiality assessment is given in Section 2 and Annex 9.

1.4 Main findings

Overall

The assessment concluded that overall prudential regulation in Australia is compliant with the Basel Framework. Twelve of the 14 components assessed are graded as compliant and two components are regarded as being largely compliant.

Against the background of a solid economic situation and a well capitalised banking system, APRA has implemented the Basel Framework in a timely and comprehensive manner. This provides a solid foundation for a more resilient financial position of the Australian banking sector.

The Prudential Standards that implement the Basel Framework are applied to all locally incorporated ADIs. As appropriate, certain regulations are applied on a proportional basis to take into account the size and complexity of the smaller domestic ADIs.

Some elements of the Basel Framework have not been implemented as APRA does not deem these aspects as relevant or material at this stage for the Australian banking sector (see Annex 11 for a list). APRA might need to reconsider its current position and introduce some of those elements of the Basel Framework should structural or business model factors evolve in Australia.

the RCAP practices, has taken a conservative approach while recognising the relative importance of these approaches for the RCAP sample for the overall rating.

Summary assessment grading

Table 3

Key components of the Basel capital framework	Grade
Overall grade:	C
Scope of application	C
Transitional arrangements	C
Pillar 1: Minimum capital requirements	
Definition of capital	LC
Credit Risk: Standardised approach	C
Credit risk: Internal ratings-based approach	LC
Credit risk: Securitisation framework	C
Counterparty credit risk framework	C
Market risk: Standardised measurement method	C
Market risk: Internal models approach	C
Operational risk: Basic indicator approach and Standardised approach	C
Operational risk: Advanced measurement approaches	C
Capital buffers (conservation and countercyclical)	C
G-SIB additional loss absorbency requirements	NA
Pillar 2: Supervisory review process	
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions	C
Pillar 3: Market discipline	
Disclosure requirements	C

Compliance assessment scale (see Section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant). (N/A) To be assessed after the Committee concludes the final Basel standards.

Main findings by component

Scope of application and transitional arrangements

APRA's implementation of the scope of application of the Basel Framework is compliant with the Basel Framework. The Basel Framework applies at every tier within a banking group as well as on a fully consolidated basis. Within this principle, the Basel Framework introduces the concept of non-consolidated subsidiaries without providing a comprehensive definition of what entities are eligible to be excluded from the scope of regulatory consolidation. APRA applies the Basel Framework on both a solo and consolidated basis. The Prudential Standards do not explicitly state that they apply at every tier within a banking group although, in practice, the structure of the internationally active ADIs within the Australian banking sector is such that the parent is domestically located and lower tiers are located outside that market. As such, APRA's view is that application of the Basel Framework at lower tiers of the banking group should be applied by the relevant host jurisdiction and duplication of this work would not be an efficient use of supervisory resources. In addition, the Prudential Standards state that APRA may determine a different composition of the regulatory consolidated group (Level 2 group) for a group of companies of which an ADI is a member. In practice, however, APRA has not varied the scope of regulatory consolidation for any ADI. Further, entities considered outside of the scope of regulatory consolidation are publicly disclosed by internationally active ADIs on a semiannual basis. Also of note is that the issue of consistent scope of application of the Basel Framework is currently under consideration, more generally, by a working group of the Basel Committee.

APRA's implementation of the transitional arrangements is also compliant with the transitional requirements outlined in Basel III. Further, APRA has chosen not to permit ADIs to use the Basel III transitional arrangements regarding deductions from capital that results in a more conservative outcome.

Definition of capital

APRA's implementation of the definition of capital requirements is largely compliant with the Basel Framework. Notwithstanding the more conservative implementation in a number of areas (as described at the end of Section 1.1), APRA's Prudential Standards differ from the Basel Framework in a few areas.

First, the Assessment Team has noted differences relative to the Framework's treatment of banks funding or holding their own capital instruments or holding those of other financial institutions. In APRA's view, the differences identified by the Assessment Team are subject to strict criteria to ensure consistency and transparency, facilitate appropriate regulatory oversight and do not offend the Basel principle underlying the relevant treatments. The following differences are noted in this area:

- The Basel III criteria for including common shares in regulatory capital (and similar terms for Additional Tier 1 and Tier 2 instruments) determine that a bank cannot directly or indirectly have funded the purchase of the instrument. APRA's Prudential Standard allows capital instruments of an ADI to be included in regulatory capital when they are purchased by a borrower as part of a well diversified and well collateralised portfolio under a full recourse loan provided by the ADI. APRA is of the view that the ADI's exposure is primarily to the overall financial position of the borrower and not to any of its own shares that may be included in the underlying collateral. This item is also currently under discussion, within the context of the Basel FAQ process, which indicates that the implementation of the Basel provision might face some practical challenges in certain circumstances and would benefit from some clarification. The Assessment Team considers that APRA's language tries to narrow the interpretation of the Basel provision and has therefore deemed the item as not material.
- Basel III requires all of a bank's investments in its own common shares, whether held directly or indirectly, to be deducted in the calculation of CET1 capital (unless already derecognised under the relevant accounting standards). In addition, any own stock which the bank could be contractually obliged to purchase should be deducted in the calculation of CET1. A similar requirement is in place for holdings of own-capital instruments other than common shares. APRA has adopted these provisions. However, in line with the previous finding, APRA (i) excludes from the definition of indirect holdings any holdings of an ADI's own shares that may be included in a borrower's (well diversified and well collateralised) portfolio used as collateral for a full recourse loan by the ADI. In addition (ii), APRA permits capital instruments of an ADI that are held as direct investments by a vehicle subject to consolidation within the ADI's financial statements to be included in regulatory capital under the following conditions: (a) the ADI (or relevant vehicle) did not fund acquisition of the capital instruments (ie they must be funded by third parties such as life insurance policyholders or other third-party investors (emphasis added)), (b) the associated risks and rewards are borne primarily by third parties; and (c) the ADI can demonstrate to APRA, if required, that decisions to acquire or sell such capital instruments are made independently and in the interests of the relevant third parties. Further, under (iii), APRA permits direct investments in shares of an institution by a special purpose vehicle established under a share-based employee remuneration scheme to be included in CET1 capital if (a) the shares represent ordinary shares of the ADI, (b) the amount included in CET1 capital is matched by an equivalent charge to profit and loss, and (c) the shares cannot be converted to another form of payment. APRA notes that there is no effective change in CET1 capital, which is reduced as a remuneration expense matched by a rise in CET1 capital reflecting the increase in shares held on behalf of employees. To require deduction from capital would essentially be a double deduction.

These exemptions will reduce the required deduction for investments in own-capital instruments. APRA does not consider these items to be inappropriate as the risks and rewards of the holding are borne by third parties and in APRA's view they do not conflict with the Basel Framework definition of "indirect holdings", namely, "exposures that will result in a loss to the bank substantially equivalent to any loss in the direct holding". However, the Assessment Team is of the view that the wording for item (ii) is general enough that it could be interpreted fairly widely by institutions and that this item is material, based on data provided by APRA and the fact that these items in general can represent large deductions for banks. The reason is that, whereas in APRA's view the provision is in line with the Basel III definition for indirect holding (in the context of the required deductions), the assessors believe that this definition was meant only to capture investments in index securities or similar investments requiring a look-through approach. Further, the other area in Basel III where similar language appears does not relate to required deductions but only intends to clarify what is considered indirect funding when an instrument is initially offered.

- Basel III requires significant investments (those above specified thresholds) in the equity of banking, financial and insurance entities to be deducted from capital. Following the same approach outlined above, banks must deduct investments in their own Additional Tier 1 and Tier 2 capital instruments. APRA requires ADIs to deduct all holdings, including those below the Framework's threshold, with two exceptions: (i) APRA excludes from the definition of indirect holdings full recourse lending to a borrower to purchase a well diversified and well collateralised portfolio that may include the relevant exposures, and (ii) APRA provides an exemption for equity exposures and other investments in financial institutions held under a legal agreement on behalf of a third party, where the third party derives exclusively and irrevocably all the gains and losses of such exposures (although no Australian institution currently holds exposures under this exemption). Related to the previous findings under the definition of capital component, APRA does not consider either item to be an indirect holding under the Basel III definition or to be inappropriate as the risks and rewards of the holding are borne by third parties. Both items (i) and (ii) are currently being discussed by the Basel Committee, as part of the ongoing FAQ process. These exemptions could reduce the effect of the required capital deduction. As in the previous finding, the Assessment Team is of the view that the wording within APRA standards is, in relation to item (ii), general enough that it could be interpreted fairly widely by institutions. However, APRA also generally applies a significantly more conservative treatment, than required under Basel III, by not utilising the threshold deductions (basket) treatment that permits a significant portion of these investments to not be deducted from regulatory capital. Currently, the Assessment Team does not consider this item to be material (based primarily on a reliable estimate of quantifiable impact).

Another difference in the definition of capital component relates to the criteria for including capital instruments in Additional Tier 1 capital (and equivalent for Tier 2). Basel III requires that the instrument must be perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem. While APRA includes the relevant Basel III text in this area, APRA standards also state that a call option and provision to convert into ordinary shares will not constitute an incentive to redeem provided there is at least two years from the date upon which the ADI may have an option to call the instrument to the nearest date upon which the conversion option may be exercised. This contradicts a Basel Committee FAQ,¹² which states examples of what is considered an incentive to redeem, including specifically "a call option combined with a requirement or an investor option to convert the instrument into shares if the call is not exercised". In APRA's view, the Basel FAQ only prohibits a call and conversion

¹² Available at: www.bis.org/publ/bcbs211.pdf.

that occur simultaneously and does not intend that there would never be a provision to call the instrument in terms of a convertible instrument as it can be argued that such a provision (the conversion) will not always constitute an incentive to redeem. Indeed, APRA is of the view that the two-year provision is an additional requirement that strengthens the existing example in the FAQ. This matter is currently being discussed as part of the ongoing FAQ process. In the view of the Assessment Team, however, the Basel FAQ does not focus on the time lag between the call option and the conversion, but instead, explicitly states that a call option and conversion feature within an instrument is an example of an incentive to redeem (and is thus not permitted). As such, the assessors disagree that these provisions are permitted within the current FAQ wording. The Assessment Team has nevertheless deemed this issue as non-material as, in its view, the extent to which an incentive to redeem is created may depend on the structure of the provisions as well as on additional factors, and it is likely that with further analysis the FAQ could be expanded to provide more risk-sensitive guidance in this area.

Finally, in the Basel III requirements for non-viability contingent capital instruments, the trigger event (which in the case of conversion causes non-CET1 capital instruments to convert into common shares) is specified as the earlier of: (i) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (ii) the decision to make a public sector injection of capital, or equivalent support without which the firm would have become non-viable, as determined by the relevant authority. Further, the Framework states the issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted. The requirements are drafted in this way to ensure that all capital providers suffer a loss prior to taxpayers in the event of a government capital injection. APRA standards state that the non-viability trigger event in relation to a bank is the earlier of: (i) the issuance of a notice in writing by APRA to the bank that conversion or write-off of capital instruments is necessary because, without it, APRA considers that the bank would become non-viable; or (ii) a determination by APRA, notified to the bank in writing, that without a public sector injection of capital, or equivalent support, the bank would become non-viable. As a result, APRA's choice of triggers does not guarantee that the issuance of any new shares upon the trigger event will occur prior to any public sector injection of capital and instead relies on APRA's ability to trigger conversion prior to government capital support. APRA is of the view that the Basel wording also does not make this guarantee (and, indeed, it would not be possible to do so). Further, APRA notes that, in Australia, federal government capital support to a failing institution has not occurred for over a century and APRA has deliberately sought to avoid moral hazard by suggesting such support may be forthcoming. Notwithstanding, data provided indicate that this is a material difference, and that its materiality will increase over time as this feature is included in all Additional Tier 1 and Tier 2 instruments going forward (per the Basel III requirements).

Capital buffers (conservation and countercyclical)

As part of APRA's Pillar 2 regime, APRA may increase an ADI's minimum capital requirement including the CET1 capital requirement. Where this occurs, APRA has the discretion to compress the Capital Conservation Buffer (CCoB) to an amount less than 2.5% of risk-weighted assets. In practice where the minimum CET1 capital requirement is greater than 4.5% and the CCoB is set at a lesser amount than 2.5%, this results in a more penal application of the minimum capital conservation ratios as the constraints to capital distributions are applied at higher minimum levels of CET1 capital. In no case does the implementation approach of APRA result in required capital ratios below what is stipulated in the Basel III agreement. The Assessment Team is comfortable that APRA's implementation maintains the objectives of the conservation buffer as outlined within the Basel standards.

APRA's implementation of the countercyclical buffer is also in line with the Basel standards.

Credit Risk: Standardised Approach

Overall, APRA's framework for the standardised approach to credit risk is compliant with the Basel Framework. The identified deviations have no (potentially) material impact on the internationally active ADIs. In Australia, 125 ADIs solely use the standardised approach to credit risk. These ADIs represent

96% of all locally incorporated ADIs and they hold approximately 11% of total banking sector assets. None of these ADIs is internationally active. The five Australian internationally active ADIs use mainly the IRB approach to credit risk, but they also apply the standardised approach to credit risk for a small part of their assets (partial use).

For claims secured by residential property, unlike the Basel framework, APRA does not restrict the concessionary risk weight of 35% to claims secured by mortgages on residential property “that is or will be occupied or that is rented by the borrower”. Notwithstanding, APRA explicitly excludes from this favourable treatment loans secured against speculative residential construction or property development. In the Assessment Team’s view, there is limited room for other uses to a residential property than those specified by the Basel Framework and excluded by APRA. Therefore this difference is deemed not material.

APRA applies the preferential risk weight for claims on Public Sector Entities (PSEs) also to claims on overseas local governments and non-commercial PSEs, whereas the Basel Framework applies the preferential risk weight for PSEs only to claims on domestic PSEs. Further, APRA exercised the discretion to treat claims on overseas state or regional governments as claims on the sovereign, and has assumed that other supervisors would have exercised their available discretion in the relevant jurisdiction as well.

APRA has not implemented the sovereign floors whereby claims on unrated banks and corporates cannot be assigned a risk weight that is preferential to that assigned to the sovereign of incorporation.

The eligibility criteria for External Credit Assessment Institutions (ECAIs) in the Basel Framework require that the individual assessments and the methodologies used by the ECAI should be publicly available. Consistent with the Australian licensing requirements for ECAIs, APRA states that such assessments and methodologies must be available only to Australian wholesale clients and foreign entities.

APRA has not implemented the disclosure requirements with regard to the use of ECAIs and of credit risk mitigation techniques.

Credit risk: Internal Ratings-Based approach

The structure and detailed requirements of the Internal Ratings-Based approach (IRB) to credit risk are largely compliant with the Basel Framework. Notwithstanding, there are a number of areas where the IRB Prudential Standards deviate from the Basel Framework.

The Basel Framework provides that residential mortgage loans (including first and subsequent liens, term loans and revolving equity lines of credit) are eligible for retail treatment regardless of exposure size so long as the credit is extended to an individual who is the owner-occupier of the property, with certain limited exceptions. Under APRA’s IRB Prudential Standards, mortgage loans are eligible for retail treatment regardless of the occupancy status of the property which, in the Assessment Team’s opinion, is a deviation from the Basel Framework. Approximately one third of Australia’s internationally active ADIs’ residential mortgage exposures are non-owner-occupied mortgages. APRA has indicated that there has not been a material difference in the performance of owner-occupied versus non-owner-occupied residential mortgages in recent history, even between 2008 and 2009, which was a period of higher default experience. However, it is not certain what the performance of these loans would be during a significant economic downturn, such as that experienced in Australia during the early 1990s, or whether the risk characteristics of such loans would remain similar to those of owner-occupied loans in such a circumstance. Accordingly the likely potential risk for capital understatement that could result from APRA’s current treatment of non-owner occupied mortgages was considered material. On this basis, the RCAP team views this deviation as potentially material.

The Basel Framework prescribes a scaling factor be applied to the risk-weighted asset amounts for credit risk assessed under the IRB approach. APRA, however, did not apply this scaling factor to the

specialised lending sub-asset class, based on its initial view that the factor was only meant to apply to the risk-weighted asset amounts determined using the risk-weight functions. Based on the data provided on the sample of ADIs, the deviation resulted in a significant understatement of capital. Hence, the RCAP team assessed this deviation as material.

The High-Volatility Commercial Real Estate (HVCRE) (one of the specialised lending (SL) sub-asset classes in the Basel Framework) is not included in the Australian IRB Prudential Standard. In the Basel Framework, the underlying principle for designating exposures to different asset classes is to ensure that exposures with different underlying risk characteristics are treated separately for capital calculation purposes so as to ensure that the amount of capital held for such exposures is commensurate with their underlying risk. The exclusion of the HVCRE category may result in HVCRE exposures being classified in the income-producing real-estate category, therefore attracting lower risk-weights than envisaged by the Basel Framework. However, APRA indicated that none of their ADIs have the type of exposures targeted by the HVCRE category; and moreover real estate underwriting standards in the Australian market are relatively stronger than those specified in the slotting criteria. In addition, APRA took a decision not to allow any internal modelling of the specialised lending (SL) risk parameters and to prescribe the (more conservative) slotting approach for all SL sub-asset classes. Accordingly the impact of not having a separate HVCRE category was deemed immaterial.

Finally, the Basel Framework prescribes a 10% floor for loss-given-default of exposures secured by residential mortgages that must be applied at the sub-segment of exposures to which the risk-weight asset formula is applied. APRA prescribes a 20% floor. This floor, however, is applied at the portfolio level. While this is not strictly in conformity with the letter and intent of the Basel Framework, the risk that loss-given-default estimates for sub-segments of exposures declining below the Basel 10% floor is deemed immaterial.

Credit risk: Securitisation framework

Overall, APRA's securitisation framework is considered compliant with the Basel Framework. None of the findings are deemed to have a (potentially) material impact. Some findings concern only the standardised approach to securitisation which is not applied by the five Australian internationally active ADIs. Instead, these ADIs apply the IRB approach to securitisation.

APRA's regulation with regard to the treatment of implicit support differs from that of Pillar 1 and Pillar 2 of the Basel Framework. On the one hand, APRA has prohibited implicit support and is in this regard super-equivalent to the Basel Framework. On the other hand, APRA has discretion with regard to the consequences it imposes in case such implicit support is provided. In particular, in the case where an ADI provides implicit support, it is not ensured that, as prescribed by the Basel Framework, the ADI would hold, at a minimum, capital against all of the exposures associated with the securitisation transaction as if they had not been securitised and that the ADI would properly disclose the implicit support and its capital impact.

APRA deviates from the Basel Framework with regard to the treatment of originating banks under the standardised approach for securitisation. Pursuant to the Basel Framework, originating banks under the standardised approach must risk-weight at 125% all retained securitisation exposures rated below investment grade. The Australian regulation does not prescribe this treatment; rather, originating ADIs under the standardised approach are also allowed to risk-weight at 350% securitisation exposures rated BB+ to BB-. Moreover, APRA grants originating ADIs a general cap on the capital requirement for securitisation exposures under the standardised approach to securitisation that is not provided in the Basel Framework.

APRA provides a broader scope of application for the Internal Assessment Approach (IAA) than the Basel framework provides. Under the Basel Framework the IAA is only available to exposures (eg liquidity facilities and credit enhancements) that banks extend to ABCP programmes. In contrast, the Australian regulation does not restrict the IAA to exposures that ADIs extend to ABCP programmes.

Instead, subject to APRA's approval, the IAA could also be used for facilities that the ADI extends to other kinds of securitisation transactions where the Ratings-Based Approach (RBA) and the Supervisory Formula Approach (SFA) cannot be used.

Finally, APRA does not apply the scaling factor to the risk-weighted asset amount for securitisation exposures under the IRB approach to securitisation.

Counterparty credit risk framework

APRA's requirements are compliant with the Basel Framework for counterparty credit risk (CCR).

Of the available approaches for CCR in the Basel Framework (Internal Models Method, Standardised Method and Current Exposure Method (CEM)), APRA has implemented the CEM and has done so in a manner that is materially consistent with the Basel Framework. The Assessment Team noted one exception that was considered to be not material; APRA's Prudential Standard does not *explicitly* state that, in determining capital requirements for hedged banking book exposures, the treatment for credit derivatives in the Basel Framework applies to qualifying credit derivative instruments. However, APRA's requirements do appear to substantively address the operational criteria and other requirements for recognising the risk-reducing effects of credit derivatives more generally.

For the treatment of mark-to-market counterparty risk losses (referred to as the credit valuation adjustment (CVA) losses), APRA has implemented the standardised CVA risk capital charge in a manner consistent with the Basel Framework for its internationally active ADIs. For ADIs with immaterial exposures to OTC derivatives, APRA has introduced a simplified CVA approach as an alternative to the Basel standardised CVA calculation whereby, with permission from APRA, an ADI must set its CVA risk capital charge equal to its counterparty credit default risk capital requirement. Among other considerations, this approach is not available to ADIs that have funded or unfunded default fund contributions to a central counterparty.

Regarding the treatment of exposures to central counterparties, APRA's requirements are consistent with the Basel Framework.

Market risk: Standardised Measurement Method

With a few minor exceptions, APRA's requirements are compliant with the Basel Framework for measuring market risk under the Standardised Measurement Method. In particular, without further specificity in APRA's Prudential Standards, there is ambiguity as to whether certain positions excluded from the trading book definition under the Basel Framework could nonetheless receive trading book capital treatment. In addition, the conditions set out in APRA's Prudential Standards regarding which positions may be included in the "qualifying" category could be read to allow certain positions to be included in that category that should instead be included in the "other" category, which is subject to higher capital requirements.

Market risk: Internal Models Approach

APRA's requirements for the Internal Models Approach for market risk are compliant with the Basel Framework.

Operational risk: Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approaches

APRA's requirements for operational risk are compliant with the Basel Framework.

The Basel Framework includes three approaches to calculate capital requirements for operational risk that differ in the level of sophistication: the Basic Indicator Approach (BIA), the Standardised Approach or Alternative Standardised Approach (ASA), and the Advanced Measurement Approaches (AMA). APRA has not implemented the BIA but this is not considered to be a deviation as a

more advanced approach (the ASA) has been adopted as the minimum standard. ADIs must use either the ASA or the AMA (after formal approval by APRA).

APRA has exercised the discretion of implementing the ASA to operational risk rather than the Standardised Approach. In practice, this means that the calculation of regulatory capital for operational risk is not primarily income-based. In compliance with the Basel Framework, the ASA is not used by large, diversified ADIs; the internationally active ADIs use the AMA.

As the ASA is the minimum default approach to determining the capital charge for operational risk, APRA has not considered it necessary to introduce either the qualifying criteria or the initial monitoring requirements. Notwithstanding, the risk management standard CPS 220 comes into effect on 1 January 2015 and will incorporate requirements similar to the Basel Framework's qualifying criteria for the Standardised Approach.

Finally, for practical reasons, in June 2011 APRA removed the Basel I capital floor. Notwithstanding, the ADIs using the AMA hold regulatory capital well above the 80% floor.

Supervisory review process

APRA's Pillar 2 supervisory review process is compliant with the Basel Framework.

The central element of APRA's Framework for prudential supervision is the entity risk assessment. Entity risk assessments are completed using APRA's Probability and Impact Rating System (PAIRS) tool. The main objectives of a PAIRS assessment are to estimate the probability that an ADI will fail and to measure the impact of the potential consequences of that failure. A PAIRS rating brings together APRA's assessment of the key risks, management, controls and capital support for an ADI which in turn, guides its supervisory action plan. APRA's supervisory actions are driven by its Supervisory Oversight and Response System (SOARS). APRA's four supervision stances are: (1) normal; (2) oversight; (3) mandated improvement; and (4) restructure.

Consistent with the Pillar 2 requirements of the Basel Framework, APRA has the power to increase capital requirements and restrict capital reductions. In particular, APRA may determine a Pillar 2 supervisory adjustment which increases an ADI's prudential capital requirement to an amount greater than the absolute minimum levels detailed in the Basel Framework. Furthermore, the Banking Act confers on APRA a comprehensive set of powers to ensure ADIs comply with regulatory and prudential requirements and enables it to address emerging concerns about an ADI's safety and soundness.

Disclosure requirements

APRA's Pillar 3 implementation is compliant with the Basel Framework.

APRA completed the implementation of Basel disclosure requirements in June 2013 when it implemented the disclosure requirements for remuneration and the Basel III disclosure requirements for capital. No major deviation with respect to Basel requirements has been identified. APRA did not implement some parts of Basel II Table 8 (General disclosure for exposures related to counterparty credit risk) and Table 11 (Market risk: disclosures for banks using the internal models approach (IMA) for trading portfolios). Notwithstanding, the information in these tables is partially made public through audited financial statements of ADIs in Australia.

2 Detailed assessment findings

The component-by-component details of the assessment of Australia's compliance with the risk-based capital standards of the Basel Framework are detailed in this part of the report. The focus is on the identified deviations and their materiality.

2.1 Scope of application and transitional arrangements

Section grade	Compliant
Summary	APRA has generally implemented the scope of application in line with the Basel agreements.
Basel paragraph no	Basel II – Paragraphs 20–23
Reference in domestic regulation	APS 001 paragraph 4, Attachment B, APS 110 and APS 111 paragraphs 4 and 5,
Findings	<p>Basel II states that the Framework will apply at every tier within a banking group and on a fully consolidated basis. Within this principle, Basel II introduces the concept of non-consolidated subsidiaries without providing a comprehensive definition of what entities are eligible to be excluded from the scope of regulatory consolidation.</p> <p>APRA applies the Basel Framework on both a solo and a consolidated basis. The Prudential Standards do not explicitly state that they apply at every tier within a banking group although in practice, the structure of the internationally active ADIs within the Australian banking sector is such that the parent is domestically located and lower tiers are located outside that market. As such, APRA's view is that application of the Basel Framework at lower tiers of the banking group should be applied by the relevant host jurisdiction and duplication of this work would not be an efficient use of supervisory resources.</p> <p>The Prudential Standards state that APRA may determine a different composition of the regulatory consolidated group (Level 2 group) for individual ADIs. In practice, however, APRA has not varied the scope of regulatory consolidation for any ADI. Further, entities considered outside of the scope of regulatory consolidation are publicly disclosed by internationally active ADIs on a semi-annual basis. Also of note is that the issue of consistent scope of application of the Basel Framework is currently under consideration, more generally, by a working group of the Basel Committee.</p>
Materiality	Not material
Basel paragraph no	Basel II paragraph 24
Reference in domestic regulation	APS 001 Attachment B
Findings	<p>Pursuant to Basel II paragraph 24 majority-owned or -controlled banking entities, securities entities and other financial entities should generally be fully consolidated. Footnote 7 of that paragraph provides examples of the type of activities that financial entities might be involved in and includes, inter alia, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking.</p> <p>APS 001 Attachment B paragraph 2(b) excludes from consolidation (a) insurance entities (including friendly societies and health funds), (b) entities acting as manager, responsible entity, approved trustee, trustee or similar role in relation to funds management, (c) non-financial (commercial) operations and (d) securitisation special purpose vehicles to which assets have been transferred in accordance with the requirements. Since Basel II paragraph 24 states that the above mentioned entities "should generally be fully consolidated", APRA has exercised discretion regarding which entities must be included in the consolidated banking group.</p>
Materiality	Not material
Basel paragraph no	Basel II paragraphs 35 and 37, Basel III paragraph 90
Reference in domestic regulation	APS 111 Attachment D paragraph 25 and APS 112 Attachment A item 16
Findings	<p>APRA does not apply the materiality levels of the Basel Framework with regard to investments in commercial (non-financial) entities (which results in a more conservative application than the Basel Framework). Materiality levels of 15% of the bank's capital for individual significant investments in commercial entities and 60% of the bank's capital for the aggregate of such investments, or stricter levels, are stipulated as minimum</p>

	requirements under the Basel II Framework. Under Basel III, significant investments in commercial entities which exceed the stipulated materiality levels now receive a 1250% risk weight. APRA requires generally the deduction from CET1 capital (instead of a 1250% risk weight) of equity holdings and other capital support provided to commercial entities other than holdings of subordinated debt in commercial entities, which are risk-weighted at 100%. Further, APRA provides exemptions from the deduction requirement (trading book, underwriting positions and equity exposures held on behalf of a third party), which are not provided in the Basel framework. Above the materiality levels it is possible the exemptions could lead to the equivalent of risk weights lower than 1250%. Below the materiality levels APRA's treatment is significantly more rigorous. For each of the five internationally active ADIs in the sample, the impact is currently below the materiality levels used by the RCAP team.
Materiality	Not material

2.2 Pillar 1: Minimum capital requirements

Section grade	Compliant
Summary	APRA has generally implemented the Pillar 1 minimum capital requirements in line with the Basel Framework.
Basel paragraph no	Basel II – Paragraphs 45–49
Reference in domestic regulation	APS 150 was revoked effective 30 June 2011.
Findings	Basel II implemented floors for banks using the advanced approaches to credit or operational risk. Specifically, it imposed a floor of 80%, from year-end 2008, for banks using the IRB approach to credit risk or the advanced measurement approaches (AMA) for operational risk. APRA implemented a 90% floor under APS 150, which it revoked in 2011. APRA has not explicitly maintained the Basel II floors for risk-weighted assets calculated using the AMA.
Materiality	APRA has stated that its calculations indicate that the ADIs using the advanced approaches remain well above the Framework's 80% floor and that there would need to be substantial change to key risk parameters coupled with unrealistic changes to portfolio composition for the floor generally to be breached. As a result, this finding is not considered material.

2.2.1 Definition of capital

Section grade	Largely compliant
Summary	APRA has generally implemented the definition of capital in line with the Basel Framework and has chosen not to permit the use of the threshold deduction treatment (basket) which is a substantial increase in conservatism and increased simplicity within its implementation of the Basel III definition of capital rules. Nonetheless, there are some areas of divergence in APRA's approach relative to the Basel framework.
Basel paragraph no	Basel III – paragraphs 52–53
Reference in domestic regulation	APS 111 paragraph 19 and Attachment B
Findings	APRA has not explicitly stated that the criteria for inclusion in common equity criteria apply to non-joint stock companies. Footnote 12 to paragraph 53 of Basel III states the common equity criteria also applies to non-joint stock companies, such as mutual, cooperatives or savings institutions. However, APRA applies its capital standards under the Basel Framework to all domestically incorporated ADIs, including those mutually owned by members. APRA has indicated that work is still being finalised on specifically addressing how the common share criteria will apply to non-joint stock companies and any changes to Prudential Standards will be communicated once the work is finished.
Materiality	Not material
Basel paragraph no	Basel III paragraph 52
Reference in domestic regulation	APS 111 paragraphs 22 and 23
Findings	APS 111 paragraphs 22 and 23 allow an ADI to include the full value of upfront fee income

	in CET1. According to APRA such income is permitted only where it has been irrevocably received by the ADI and is available to meet losses even though it may not be recognised upfront in earnings for accounting purposes. Such amounts are the counterpoint to APRA's requirement for capitalised expenses to be deducted upfront from CET1. Neither recognition of income nor deduction of capitalised expenses have been specifically addressed in Basel II paragraph 52.
Materiality	Not material
Basel paragraph no	Basel III paragraph 52
Reference in domestic regulation	APS 111 paragraphs 20(d) and 21
Findings	Pursuant to Basel III paragraph 52, dividends are removed from CET1 capital in accordance with applicable accounting standards. APRA has adopted this requirement by requiring dividends that have been declared but not yet paid to be deducted from capital. Under APS 111 paragraph 21, the amount of declared dividends to be deducted may be reduced by the expected proceeds of a Dividend Reinvestment Plan (DRP), where dividends are used to purchase new shares of the ADI. According to APRA, DRPs are not dealt with under Australian Accounting Standards. APRA's provisions relating to DRPs are not provided in Basel III paragraph 52.
Materiality	Not material. APRA's recognition of the expected proceeds of a DRP is a timing issue only. Under a DRP, the ADI typically has prior binding agreements from shareholders to the automatic reinvestment of their future dividends in the form of shares of the ADI. In order for the proceeds of DRPs to be recognised in regulatory capital, shareholders must receive new issue of shares in place of their dividends. Consequently, at the point of declaration of a dividend, rather than reduce retained earnings by the amount of the proposed dividend payment, an ADI may recognise in retained earnings, up until the date of payments of dividends and issue of ordinary shares, the proceeds of the dividend payment which will be automatically exchanged for the issue of new ordinary shares to shareholders. As the ADI already holds the proceeds, the future issue of ordinary shares is, in effect, recognised by not reducing the CET1 capital of the ADI between the date of declaration of dividends and date of payment of dividends/issue of new ordinary shares. The period between declaration of dividends and issue of new ordinary shares under a DRP in normal circumstances should only be a month or two.
Basel paragraph no	Basel III – Paragraphs 52–53, 54–56, 57–59
Reference in domestic regulation	APS 111 paragraphs 19–26, 28, 31, 39–40, Attachments B E and H
Findings	APRA has introduced several exclusions to the definition of indirect funding by a related party required under Basel III. Basel III criterion 11 for common shares (and similar terms for AT1 and T2 capital instruments) requires that a bank cannot directly or indirectly have funded the purchase of the instrument. APRA's criterion in APS 111, Attachment B 1(k), and the equivalent for AT1 and T2 capital instruments, only states that the instrument must be directly issued by the issuer, and, except where otherwise permitted, cannot have been purchased or indirectly or directly funded by the issuer, any member of the group to which the issuer belongs, or any related entity. Footnote 14 in APS 111 excludes from the definition of "indirect funding" full recourse lending to a borrower to fund the purchase of a well diversified and well collateralised portfolio that may include the capital instruments. In APRA's view, this does not offend the principle that capital must not be artificially created or double-counted. APRA only allows capital purchased under such loans to be included in regulatory capital if the funding ADI has full recourse to the financial position of the borrower, rather than simply to any capital instruments that may form part of the underlying collateral. APRA cites this as an example of activity that does not fall within the Basel III definition of indirect holding, namely, "exposures that will result in a loss to the ADI substantially equivalent to any loss in the direct holding".
Materiality	Not material. APRA's regulation tries to narrow the interpretation of the Basel provision.
Basel paragraph no	Basel III – Paragraphs 54–56, 57–59
Reference in domestic regulation	APS 111 paragraph 28, 39–40 and Attachment E, APS 111, paragraph 31, Attachment H
Findings	APRA's Prudential Standard prohibiting what is considered an incentive to redeem for Additional Tier 1 and Tier 2 instruments contradicts a BCBS FAQ in this area. Basel III Additional Tier 1 Criterion (and equivalent for Tier 2) states the instrument must be perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem. BCBS FAQ 7 lists several examples of what would be considered to be an incentive to redeem which includes: a call option combined with a requirement or an investor option to convert the instrument into shares if the call is not exercised.

	<p>APS 111 Attachment E sub-paragraph 4(e) prohibits an incentive to redeem using the Basel wording in FAQ 7. Paragraph 5 (and equivalent for Tier 2) states that a call option and provision to convert into ordinary shares will not constitute an incentive to redeem provided there is at least two years from the date upon which the ADI may have an option to call the instrument to the nearest date upon which the conversion option may be exercised. This contradicts the BCBS FAQ by introducing the two-year limit. APRA has stated it does not consider the above to constitute an incentive to redeem as it is of the view BCBS FAQ 7 only prohibits a simultaneous call option and conversion. APRA is of the view that the requirements in paragraph 5 strengthen FAQ 7 by prohibiting calls and conversions within the two-year window, not just those occurring on the same date.</p> <p>APS 111 Attachment E paragraph 10 does not consider a mechanism that requires a holder to sell the instrument to a nominated party other than the issuer or a related entity of the issuer as an incentive to redeem in the meaning of Basel III paragraph 55 criterion 4, provided there is at least two years from the date upon which the holder is required to sell the instrument to the nearest subsequent date upon which conversion may be exercised. APRA is of the view that it is fully compliant. As stated above, it implements the FAQ in 4(a) of Attachment E as worded in the FAQ. APRA maintains that paragraph 5 extends rather than restricts paragraph 4(a) to cover all calls and conversions and so is super-equivalent. The FAQ does not prohibit any calls and a reading that APRA's paragraph 5 breaches wording already included in paragraph 4(a) does not appear to be supported by the FAQ. For the reasons outlined above, APRA is of the view that its provision is consistent with the Basel Framework.</p>
Materiality	Not material. In the view of the Assessment Team, an incentive to redeem may depend on the structure of the provisions as well as on additional factors.
Basel paragraph no	Basel III paragraphs 69–70
Reference in domestic regulation	APS 111 Attachment D paragraphs 22 and 23
Findings	APS 111 Attachment D paragraphs 22 and 23 do not state that the deferred tax liabilities permitted to be netted against deferred tax assets must exclude amounts that have been netted against the deduction of goodwill, intangibles, and defined benefit superannuation assets (Basel III paragraph 69). APRA intends reviewing APS 111 in 2014 and will then rectify this oversight.
Materiality	Not material
Basel paragraph no	Basel III paragraph 75
Reference in domestic regulation	APS 111 Attachment D paragraph 26
Findings	APS 111 Attachment D paragraph 26 is not in line with Basel III paragraph 75 as amended on 25 July 2012 (BCBS's press release of 25 July 2012). It does not include with regard to derivative liabilities that all accounting valuation adjustments arising from the bank's own credit risk must be derecognised and that the offsetting between valuation adjustments arising from the bank's own credit risk and those arising from its counterparties' credit risk is not allowed. According to APRA the requirement is applied in practice and it was just missed due to the later publication by Basel. APRA will amend the standard for incorporation.
Materiality	Not material
Basel paragraph no	Basel III paragraph 76
Reference in domestic regulation	APS 111 Attachment D paragraph 34
Findings	Basel III paragraph 76 deals with a defined benefit pension fund that is an asset on the balance sheet. This asset should be deducted in the calculation of CET1. But assets in the fund to which the bank has unrestricted and unfettered access can offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank. In contrast, APS 111 Attachment D paragraph 34 deals with the "surplus" in a defined benefit fund which should generally be deducted but could be included as an asset for capital adequacy purposes where the ADI is able to demonstrate unrestricted and unfettered access to a fund surplus in a timely manner. Subject to APRA approval, an ADI may include the surplus in its risk-weighted assets at a 100% risk weight rather than deducting the surplus.
Materiality	Not material. The background for APRA's approach is that whilst an ADI may have unfettered and unrestricted access to a surplus, it is not necessarily in control of the assets making up the surplus on a day to day basis, and further, those assets making up a surplus may not themselves be specifically identifiable by an ADI amongst the portfolio of assets

	held by a superannuation fund. As such, APRA did not consider it appropriate to permit the application of the risk weight of some selected individual assets held by a superannuation fund to be used and instead applied a simple 100% risk weight to the identified "surplus" amount in a superannuation fund. Defined benefit schemes are a declining feature of Australia's superannuation system and any amounts involved are unlikely to be significant.
Basel paragraph no	Basel III paragraph 78
Reference in domestic regulation	APS 111 – paragraphs 39–41, Attachment D, paragraphs 15–17
Findings	<p>Basel III paragraph 78 requires that all of a bank's investments in its own common shares, whether held directly or indirectly, will be deducted in the calculation of CET1 capital (unless already derecognised under the relevant accounting standards). In addition, any own stock which the bank could be contractually obliged to purchase should be deducted in the calculation of CET1. The treatment will apply irrespective of the location of the exposure in the banking book or the trading book. In addition:</p> <p>Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.</p> <p>Banks should look through holdings of index securities to deduct exposures to own shares. Following the same approach outlined above, banks must deduct investments in their own AT1 and T2 capital instruments. APRA has adopted this approach. However, APRA permits capital instruments of an ADI, member of a group headed by an ADI or a non-operating holding company that are held as direct investments by a vehicle subject to consolidation within the ADI's financial statements to be included in regulatory capital under the following conditions: (a) neither the ADI, nor the relevant vehicle can have funded the acquisition of the capital instruments (ie they must be funded by third parties such as life insurance policyholders or other third-party investors, (b) the associated risks and rewards are borne primarily by third parties); and (c) the ADI can demonstrate to APRA, if required, that decisions to acquire or sell such capital instruments are made independently and in the interests of the relevant third parties. APRA considers that this complies with the Framework because the risks and rewards are held by third parties and the investments do not meet the Basel definition of "indirect holdings". APRA also allows direct investments in shares of an ADI by an SPV established under a share-based remuneration scheme to be included in CET1 capital only if the shares are ordinary shares of the ADI, the amount included in CET1 capital is matched by an equivalent charge to profit and loss and the shares cannot be converted to another payment form. In effect, there is no change to regulatory capital arising from APRA's approach. These exemptions will reduce the required deduction for investments in own-capital instruments.</p>
Materiality	Material. The wording is considered general enough to be interpreted fairly widely. Based on data provided by APRA, these items can represent large deductions for banks.
Basel paragraph no	Basel III paragraphs 80–83, 84–86
Reference in domestic regulation	APS 111, Attachment D paragraph 8
Findings	<p>APRA applies exemptions to the requirement for deduction of investments in capital instruments of financial institutions. However they also generally apply a more conservative treatment by not utilising the threshold deductions (basket) or the treatment of investments that do not meet the significance threshold in Basel III paragraph 80. Basel III paragraphs 80–84 require significant investments in the equity of banking, financial and insurance entities to be deducted from capital.</p> <p>Investments include direct, indirect and synthetic holdings. For example, banks should look through holdings of index securities.</p> <p>Holdings in both the banking book and trading book are included.</p> <p>Underwriting positions held for five working days or less can be excluded.</p> <p>Following the same approach outlined above banks must deduct investments in their own AT1 and T2 capital instruments.</p> <p>APS 111 Attachment D paragraph 8 states: "Unless otherwise indicated, an ADI must deduct from the corresponding category of capital direct, indirect and synthetic equity exposures, guarantees and other forms of capital support, and holdings of Additional Tier 1 Capital and Tier 2 Capital instruments in ADIs and overseas deposit-taking institutions and their subsidiaries, insurance companies and other financial institutions.</p> <p>This includes:</p> <p>equity exposures, guarantees and other forms of capital support held in the banking book; net long positions in equity held in the trading book (refer to APS 116); and underwriting positions in equity held for more than five working days.</p>

	<p>An ADI is not required to deduct:</p> <p>equity exposures in ADIs and equivalent overseas deposit-taking institutions and their subsidiaries, insurance companies and other financial institutions held under a legal agreement on behalf of a third party, even if held in the name of the ADI (or other members of the Level 2 group), where the third party derives exclusively and irrevocably all the gains and losses of such exposures and investments;</p> <p>underwriting positions in equities held for five working days or less. Such exposures must be risk-weighted at 300% if listed and at 400% if unlisted; and</p> <p>at Level 1, equity exposures held in other ADIs or overseas deposit-taking institutions and their subsidiaries, and insurance companies that are subsidiaries of the ADI. Such exposures, after deduction of any intangibles component, must be risk-weighted at 300% if listed and 400% if unlisted.”</p> <p>Indirect holdings represent exposures that will result in a loss to the ADI substantially equivalent to any loss in the direct holding. This excludes, for example, full recourse lending to a borrower to purchase a well diversified and well collateralised portfolio that may include the relevant exposures.</p> <p>There are differences between the Basel III standard and the implementation by APRA, notably:</p> <p>APRA's exclusion from the definition of indirect holdings full recourse lending to a borrower to purchase a well diversified and well collateralised portfolio that may include the relevant exposures. As stated previously, it is APRA's view that an ADI's exposure is primarily to the borrower and not the underlying collateral and its approach meets the Framework definition of "indirect holdings".</p> <p>The exemption in APS 111 Attachment D paragraph 8(d) for equity exposures held under a legal agreement on behalf of a third party is not provided in Basel III. Again, APRA is of the view that there is no impact on regulatory capital because the risks and rewards are borne by a third party,</p> <p>APS 111 Attachment D paragraph 8 does not explicitly say that banks should look through holdings of index securities to determine their underlying holdings of capital. APRA is of the view that, as this was given as an example in the Basel III text, it was unnecessary to include it.</p> <p>The reference at the beginning of APS 111 Attachment D paragraph 8 to "synthetic equity exposures" instead of "synthetic holdings of capital instruments" in Basel III paragraph 80.</p>
Materiality	Not material
Basel paragraph no	Minimum requirements to ensure loss absorbency at the point of non-viability (PON) – paragraphs 1–4, 5–7
Reference in domestic regulation	APS 111 Attachment J
Findings	<p>The BCBS PON requirements specified the trigger event as the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support without which the firm would have become non-viable, as determined by the relevant authority.</p> <p>Further, paragraph 5 states the issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.</p> <p>APS 111 – Attachment J paragraph 3 states the non-viability trigger event in relation to an ADI is the earlier of: (a) the issuance of a notice in writing by APRA to the ADI that conversion or write-off of capital instruments is necessary because, without it, APRA considers that the ADI would become non-viable; or (b) a determination by APRA, notified to the ADI in writing, that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.</p> <p>APRA's choice of triggers does not guarantee that the issuance of any new shares as a result of the trigger event will occur prior to any public sector injection of capital (stated in paragraph 5 of the PON requirements).</p> <p>APRA is of the view that is not appropriate to include wording that might give rise to moral hazard, given that no federal government has provided capital support to a troubled institution for over a century.</p>
Materiality	Material. There is no guarantee that Basel requirement is met. APRA relies on the ability to trigger conversion prior to any public sector injection. Data indicate that this is potentially material, and this may increase over time.

2.2.2 Capital buffers (conservation and countercyclical)

Section grade	Compliant
Summary	APRA has generally implemented the capital buffers (conservation and countercyclical) in line with the Basel Framework
Basel paragraph no	Basel III paragraph 129
Reference in domestic regulation	APS 110 paragraphs 25–26
Findings	As part of APRA's Pillar 2 regime, APRA may increase an ADI's minimum capital requirement including the CET1 capital requirement. Where this occurs, supervisors have the discretion to compress the Capital Conservation Buffer (CCoB) to an amount less than 2.5% of risk-weighted assets (subject to a floor of 7% for total CET noted in APS 110 paragraph 25). In practice, where the minimum CET1 capital requirement is greater than 4.5% and the CCoB is set at a lesser amount than 2.5% (subject to the floor), this results in a more penal application of the capital conservation ratios as the constraints are applied at higher minimum levels of CET1. In no case does the APRA approach result in a lower required capital ratio than stipulated under the Basel III requirements.
Materiality	Not material
Basel paragraph no	Basel III paragraphs 131, 147 and 148
Reference in domestic regulation	APS 110 Attachment B paragraph 1
Findings	The table in APS 110 Attachment B paragraph 1 differs from the table in Basel III paragraph 131. Pursuant to the Basel III table, a 100% minimum capital conservation ratio is applied if the buffer is less than or equal to 0.625%, whereas pursuant to APRA's table a 0.625% buffer could lead to a minimum capital conservation ratio of 80%. Accordingly, the minimum capital conservation ratio according to the table in APS 110 Attachment B paragraph 1 for an ADI with a CET1 ratio of 5.125% and CET1 prudential capital requirement of 4.5% would be 80%, whereas according to the table of Basel III paragraph 131 it would be 100%. These are corresponding differences in the following rows of the tables. Due to this, the table in APS 110 Attachment B paragraph 1 does also not match with the tables in Basel III paragraphs 147 and 148.
Materiality	Not material. According to APRA this is an unintended outcome and reflects the unintended loss of the "less than or equal" symbol in the printed text in Table 1 of Attachment B of APS 110. APRA will seek to correct when APS 110 is next amended, which will be before the capital conservation comes into effect. At present, this oversight has no practical effect.
Basel paragraph no	Basel III paragraphs 132(a)–(b)
Reference in domestic regulation	APS 110, paragraph 27, Attachment B paragraphs 3–4
Findings	With reference to the conservation buffer, Basel III stipulates where a bank does not have positive earnings and has a CET1 ratio less than 7% it would be restricted from making positive net distributions.
Materiality	Not material. APRA has stated that this provision was inadvertently missed and will be corrected in the next revision of APS 110 over the next one to two years.
Basel paragraph no	Basel III paragraph 149
Reference in domestic regulation	APS 330, paragraph 9 and Attachment A, Table 1, item 64
Findings	APRA's standards do not explicitly say that the countercyclical buffer should be based on the latest relevant jurisdictional countercyclical buffers that are available at the date they calculate their minimum capital requirement.
Materiality	Not material. APRA will rectify. APRA expects APS 330 will be reviewed to incorporate this requirement over the next one to two years.

2.2.3 Credit risk: Standardised Approach

Section grade	Compliant
Summary	Overall, APRA's framework for the standardised approach to credit risk is compliant with

	<p>the Basel Framework. The identified deviations have no (potentially) material impact on the internationally active ADIs.</p> <p>In Australia 125 ADIs solely use the standardised approach to credit risk. These ADIs represent 96% of the ADIs that are required to implement the Basel Framework in Australia and they hold approximately 11% of total banking sector assets. None of these ADIs are internationally active.</p> <p>The five Australian internationally active ADIs mainly use the IRB approach to credit risk but they also apply the standardised approach to credit risk for a small part of their assets. In regard to the five Australian internationally active ADIs, risk-weighted assets under the standardised approach to credit risk account for about 2.6% (least affected ADI) to 13.8% (most affected ADI) of total credit risk-weighted assets.</p> <p>APRA considers the possibility of an ADI solely using the standardised approach to credit risk becoming internationally active and the possibility of an internationally active ADI reverting to the standardised approach as remote.</p>
Basel paragraph no	Basel II paragraph 54
Reference in domestic regulation	APS 112, Attachment A, Items 2 and 5
Findings	<p>Basel II paragraph 54 allows, at national discretion, application of a lower risk weight to banks' exposures to their sovereign or central bank, provided the exposures are denominated in domestic currency and funded in that currency. This is to say the bank would also have corresponding liabilities denominated in the domestic currency.</p> <p>APS 112 Attachment A Items 2 and 5 lack the funding requirement.</p>
Materiality	<p>Not material. The ADIs that solely use the standardised approach to credit risk tend to have balance sheets that are mostly (if not entirely) funded in Australian dollars so the relevant ADIs would always have more Australian dollar liabilities than their Australian dollar exposure to the Australian government/central bank. In regard to the five Australian internationally active ADIs their claims on sovereigns under the standardised approach to credit risk amount to 0.4% of their total exposures. Data in regard to sovereign exposures split by Australia versus overseas sovereigns were not available.</p>
Basel paragraph no	Basel II paragraphs 57–58
Reference in domestic regulation	APS 112, Attachment A, Items 6 and 7
Findings	<p>According to Basel II paragraph 57 claims on domestic PSEs will be risk-weighted, at national discretion, according to either option 1 or option 2 for claims on banks. APRA's approach in APS 112 Attachment A Item 7 is generally equivalent or conservative to option 2. Notwithstanding, APRA treats claims on overseas local governments and overseas non-commercial PSEs in the same manner as domestic equivalents.</p> <p>In a similar vein, Basel II paragraph 58 allows claims on certain domestic PSEs to be treated as claims on the sovereigns in whose jurisdictions the PSEs are established. Where this discretion is exercised, other national supervisors may allow their banks to risk-weight claims on such PSEs in the same manner.</p> <p>APRA exercised the discretion to treat claims on certain domestic PSEs (State or Territory Governments in Australia) as claims on the sovereign. APS 112 Attachment A Item 6 treats claims on overseas state and regional governments in the same manner as domestic equivalents. By doing so, APRA has essentially assumed that other supervisors have exercised their discretion to treat claims on their state and regional governments as equivalent to claims on their sovereign.</p>
Materiality	<p>Not material. The risk of the understatement of capital is considered to be small as most countries appear to have exercised the relevant discretion. Moreover, the sorts of exposures that are impacted by the policy are not undertaken by the ADIs that solely use the standardised approach to credit risk as they generally do not operate overseas. In regard to the five Australian internationally active ADIs, data on their claims on PSEs under the SA were not available.</p>
Basel paragraph no	Basel II paragraphs 60–64
Reference in domestic regulation	APS 112 Attachment A, Item 9
Findings	<p>APRA adopted option 2 for claims on banks. APS 112 does not include the sovereign floor whereby no claim on an unrated bank may receive a risk weight lower than that applied to claims on the sovereign of incorporation.</p>
Materiality	<p>Not material. In regard to the five Australian internationally active ADIs claims on banks under the standardised approach to credit risk amount to 0.0% of their total exposures. APRA expects APS 112 will be reviewed to incorporate this omission over the next one to</p>

	two years.
Basel paragraph no	Basel II paragraphs 66–68
Reference in domestic regulation	APS 112, Attachment A, Item 15
Findings	APS 112 Attachment A Item 15 does not include the sovereign floor in Basel II paragraph 66 whereby no claim on an unrated corporate may receive a risk weight preferential to that assigned to claims on the sovereign of incorporation.
Materiality	Not material. The potential impact of the deviation seems to be very small as unrated corporate exposures attract a 100% risk weight and the only sovereigns risk-weighted higher than this are those rated below B-. According to APRA ADIs that solely use the standardised approach to credit risk have minimal exposure to corporate counterparties in such jurisdictions. In regard to the five Australian internationally active ADIs, their claims on unrated corporates under the standardised approach to credit risk amount to approximately 1.2% of their total exposures. Data in regard to their claims on unrated corporates based in countries with a credit assessment below B- were not available.
Basel paragraph no	Basel II paragraph 72
Reference in domestic regulation	APS 112, Attachment A, Item 11, Attachment D Paragraph 5
Findings	<p>Pursuant to Basel II paragraph 72, claims fully secured by mortgages on residential property that “is or will be occupied by the borrower, or that is rented”, may be risk-weighted at 35%. In applying the 35% risk weight, the supervisory authority should satisfy itself, according to its national arrangements for the provision of housing finance, “that this concessionary risk weight is applied restrictively for residential purposes” and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules.</p> <p>APS 112 Attachment A item 11 in conjunction with Attachment D paragraph 5 provides a concessionary risk weight for claims secured against eligible residential mortgages depending on qualitative requirements, the loan-to-valuation ratio (LVR) and the existence of mortgage insurance by an acceptable lenders mortgage insurer (LMI). Overall, only exposures that have been fully assessed by the ADI with a loan-to-value ratio of less than 80% or with at least 40% lenders mortgage insurance are eligible for a 35% risk weight.</p> <p>For the concessionary risk weight, APRA does not require that the secured loan has residential purposes. While it could be argued that the Basel treatment should be for financing the property only, the interpretation that it is the purpose of the collateral (or property) what matters is also valid. APRA focuses on the residential purpose of the property. Under APRA’s definition, loans for purposes other than housing (such as for business or other personal purposes) can be assigned the concessionary risk weight so long as they are secured by residential mortgages. This issue has not been assessed as a difference by the Assessment Team as both interpretations of the Basel rule are valid.</p> <p>In addition, unlike the Basel provision, APRA’s standards (APS 112 Attachment A item 11 in conjunction with Attachment D paragraph 5) do not require that to apply this concessionary risk weight the residential property “is or will be occupied by the borrower or that it is rented by the borrower”. Notwithstanding, APRA explicitly excludes from this favourable treatment loans secured against speculative residential construction or property development (APS 112 Attachment D paragraph 4). In the Assessment Team’s view, there is limited room for other uses to a residential property than those specified by Basel and excluded by APRA. Therefore this difference is deemed not material.</p>
Materiality	Not material in regard to the five Australian internationally active ADIs as their claims secured by eligible residential mortgages under the standardised approach to credit risk amount to approximately 1.3% of their total exposures. With regard to those ADIs that solely use the standardised approach to credit risk it is unlikely that this issue is material, even if residential mortgage exposures (as defined by APRA) comprise up to 80% of their total loans, because “buy to let” is also included in Basel II paragraph 72 and real estate developers are explicitly excluded from the concessionary risk weight by APS 112.
Basel paragraph no	Basel II paragraph 78
Reference in domestic regulation	APS 112, Attachment D paragraph 12
Findings	<p>Due to the deviation in APRA’s definition of claims secured by residential property, the preferential risk weight of 100% for past due loans in APS 112 Attachment D Item 12 could be applied to loans which do not qualify as claims secured by residential property within the meaning of Basel II paragraph 72.</p> <p>Furthermore, APS 112 Attachment D Item 12 applies the original risk weight to mortgage insured claims to the extent that the total of loans and claims covered by a single insurer</p>

	that are past due for more than 90 days and/or impaired do not exceed the ADI's large exposure limit. This is not provided for in Basel II paragraph 78. On the other hand, APRA did not exercise the discretion in Basel paragraph 78 to reduce the risk weight to 50% where specific provisions are no less than 20%.
Materiality	See the assessment of materiality above for the finding in regard to Basel II paragraph 72, which also applies here.
Basel paragraph no	Basel II paragraphs 90–91
Reference in domestic regulation	Guidelines on Recognition of External Credit Institutions (January 2013)
Findings	Basel II paragraph 91 defines the eligibility criteria for ECAIs. Under the criterion "International access/Transparency", the individual assessments and the methodologies used by the ECAI should be publicly available. Paragraph 16 of Attachment 1 of APRA's <i>Guidelines on Recognition of External Credit Institutions</i> states that such assessments and methodologies must be available to Australian wholesale clients and foreign entities. According to APRA, the terminology used in its guidance material is consistent with the licensing requirements for ECAIs in Australia which, in effect, prevent the provision of credit assessments to retail investors.
Materiality	Not material
Basel paragraph no	Basel II paragraph 95
Reference in domestic regulation	No corresponding domestic regulation
Findings	According to Basel II paragraph 95, banks must disclose ECAIs that they use for the risk-weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by supervisors through the mapping process as well as the aggregated risk-weighted assets for each risk weight based on the assessments of each eligible ECAI. APRA has not implemented this requirement.
Materiality	Not material. All Australian internationally active ADIs must fully comply with Basel's Pillar 3 requirements.
Basel paragraph no	Basel II paragraph 116
Reference in domestic regulation	No corresponding domestic regulation
Findings	Pursuant to Basel II paragraph 116, the Pillar 3 requirements of the Basel Framework must also be observed for banks to obtain capital relief in respect of credit risk mitigation (CRM) techniques. The Pillar 3 disclosures relating to CRM techniques detailed in APS 330 do not apply to those ADIs using the standardised approach to credit risk solely.
Materiality	Not material. See above the assessment of materiality of the finding in regard to Basel II paragraph 95, which also applies here.

2.2.4 Credit risk: Internal Ratings-Based approach

Section grade	Largely Compliant
Summary	The structure and detailed requirements of the internal ratings-based approach (IRB) are largely compliant with the Basel Framework notwithstanding a number of areas where the IRB Prudential Standards deviate from the Basel Framework. One deviation relates to the definition of retail exposures where some of the criteria for retail eligibility were not included, specifically in respect of residential mortgage loans. Further, APRA did not apply the 1.06 scaling factor, prescribed for risk-weighted asset amounts calculated under the IRB approach, to the specialised lending asset class. APRA has also excluded the high volatility commercial real estate sub-asset class. There was also a deviation in respect of the eligibility of public sector entities for sovereign treatment which is also inconsistent with the Basel Framework. In this regard, APRA has indicated that amendments will be made to the Prudential Standards to bring them in line with the Framework. Whilst APRA prescribes a higher loss given default floor for residential mortgage loans than what is outlined in the Basel Framework, the application of the floor was found to be inconsistent with the letter of the Basel Framework.
Basel paragraph no	Paragraph 44
Reference in domestic regulation	None
Findings	In order to broadly maintain the aggregate level of the minimum capital requirements while also providing incentives for banks to adopt the advanced approaches, the Basel Framework prescribes a 1.06 scaling factor to the risk-weighted amounts for credit risk assessed under the IRB approach. In this regard APRA did not apply the scaling factor to the specialised lending exposures subject to the slotting approach. At the time of drafting the IRB Prudential Standards APRA took the view that the scaling factor only applied to the capital requirements that are determined using the risk-weight functions. However a correct reading of the Basel Framework clearly indicates that the scaling factor is intended to apply broadly to the IRB risk-weighted assets regardless of the specific method used.
Materiality	Material. Based on the data of the sample of ADIs provided, the capital was understated by over 8 basis points (bps) for one ADI, between 6 bps and 7 bps for two ADIs and between 3 bps and 5 bps for the other two ADIs.
Basel paragraph no	Paragraph 215 and 227: Categorisation of exposures – High-volatility commercial real estate
Reference in domestic regulation	None
Findings	Basel paragraph 215 read together with paragraph 227 requires a bank that employs the IRB approach for credit risk to inter alia define 5 specialised lending (SL) sub-asset classes under the corporate asset class. These are (a) project finance, (b) object finance, (c) commodities finance, (d) income-producing real estate, and (e) high-volatility commercial real estate (HVCRE). However, of the five sub-asset classes, the IRB Prudential Standards excluded the HVCRE sub-asset class. In their motivation for the exclusion, APRA indicated that at the time of Basel II implementation, the category would have applied to a relatively small portion of ADIs' real estate lending activities. Moreover, defining such a category could have potentially signalled APRA's acceptance of the high-risk lending targeted by the HVCRE category, thus potentially incentivising ADIs to loosen underwriting standards. The perverse incentive for loosening underwriting standards was considered the greater prudential risk, hence the decision to exclude the category. The result of the exclusion is that exposures that may qualify for HVCRE capital treatment under both the slotting approach and the advanced IRB approach are classified under the income-producing real estate sub-asset class, which may attract lower risk weights than what the risk characteristics of these exposures may warrant. That said, APRA took a decision to prescribe the slotting approach for all specialised lending sub-asset classes and not to allow any internal modelling of the SL risk parameters owing to the observed inadequacy of ADIs internal rating systems to produce appropriate internal risk parameter estimates for these exposures and more general concerns relating to the higher risk nature of this type of lending.
Materiality	Paragraph 277, 282 and 380 of the Basel Framework allow for discretion whereby supervisors could prescribe lower risk weights to SL exposures provided they determine that banks' underwriting standards and other risk characteristics are substantially stronger than those specified in the slotting criteria. In this regard APRA indicated that underwriting standards on real estate lending are relatively prudent, with loan-to-value ratios within

	acceptable range. Based on these factors, the deviation was found to be immaterial.
Basel paragraph no	Paragraph 229: Definition of sovereign exposures
Reference in domestic regulation	APS 113, paragraph 44
Findings	Basel paragraph 229 allows certain PSEs treated as sovereigns under the standardised approach to be included within the IRB sovereign asset class. APRA's IRB Prudential Standard, however, defines a somewhat wider range of eligible PSEs in this respect (refer to findings for Basel paragraphs 57–58 above). APRA has indicated that the IRB Prudential Standards will be amended to bring them in line with the Basel Framework.
Materiality	Not material. For 4 of the sampled ADIs the estimated capital understatement is well below 1.5 basis points, whilst for the other ADI there is no impact.
Basel paragraph no	Paragraph 231: Definition of retail exposures
Reference in domestic regulation	APS 113, paragraph 46,47; APG 113, paragraph 2
Findings	The Basel Framework provides that residential mortgage loans (including first and subsequent liens, term loans and revolving equity lines of credit) are eligible for retail treatment regardless of exposure size so long as the credit is extended to an individual who is the owner-occupier of the property, with certain limited exceptions. Under APRA's IRB Prudential Standards, mortgage loans are eligible for retail treatment regardless of the occupancy status of the property, which is a deviation from the Basel Framework. Approximately one third of Australia's internationally active ADIs' residential mortgage exposures are non-owner-occupied mortgages. APRA has indicated that there has not been a material difference in the performance of owner-occupied versus non-owner-occupied residential mortgages in recent history even between 2008 and 2009, which was a period of higher default experience. However, it is not certain what the performance of these loans would be during a significant economic downturn, such as that experienced in Australia during the early 1990s or whether the risk characteristics of such loans would remain similar to those of owner-occupied loans in such a circumstance. On this basis, the RCAP team views this deviation as potentially material.
Materiality	Potentially material
Basel paragraph no	Paragraph 266: Transition arrangement – Loss-Given-Default (LGD) floor for retail exposures secured by residential property
Reference in domestic regulation	APS 113, Attachment C paragraph 3
Findings	Paragraph 266 of the Basel text prescribes a 10% floor for LGD for retail exposures secured by residential mortgage properties. More importantly the text indicates that this floor must be applied at the sub-segment of exposures to which the risk-weight asset formula is applied. The spirit of the Basel Framework, in the RCAP team's view, is that LGD estimates used for capital calculation purposes are meant to be reflective of downturn economic conditions and, by implication, capture the fact that in those downturn periods loss rates tend to be higher than average. In that regard, given the Committee's observed lack of downturn historical experience coupled with the incentive for banks to adopt more granular segmentation approaches in their rating system, this could result in significantly lower LGD estimates. The floor was thus meant to limit the extent to which the estimates should be allowed to decline as a result of banks adopting more granular segmentation approaches in their rating system development. Whilst the RCAP team noted that APRA prescribes a higher floor of 20%, that floor is applied at the portfolio level. Potentially the deviation from the Basel Framework could arise in scenarios where an ADI has segmented their residential mortgage into various segments in order to assess the risk more granularly. In this regard, if the floor is applied at the consolidated portfolio level, it could imply that the segment LGD estimates are not floored at the prescribed 10%, with the consequence that the resulting risk-weighted assets are not based on the appropriate LGD estimates as envisaged in the Basel Framework. APRA however indicated that processes adopted for reviewing and monitoring ratings systems are sufficiently robust to mitigate such scenarios. Moreover, the decision to set the higher portfolio floor was informed by APRA's observed inadequacy of the ADIs' rating system segmentation. The RCAP team, however, deemed this risk to be immaterial.
Materiality	Not material.

2.2.5 Securitisation framework

Section grade	Compliant
Summary	Overall, APRA's securitisation framework is in line with the Basel Framework. Some findings concern only the standardised approach to securitisation, which is not applied by the five Australian internationally active ADIs. Instead, these ADIs apply the IRB approach to securitisation. None of the findings is deemed to have a (potentially) material impact.
Basel paragraph no	Basel II paragraph 44
Reference in domestic regulation	There is no corresponding regulation
Findings	APRA does not apply the scaling factor of 1.06 to the risk-weighted asset amounts for securitisation exposures under the IRB approach to securitisation.
Materiality	No material impact according to the impact assessment in regard to the ADIs in the data sample.
Basel paragraph no	Basel II paragraph 539
Reference in domestic regulation	APS 120 paragraph 12(s) and 12(aa)
Findings	Basel II paragraph 539 demands for a traditional securitisation at least two different stratified risk positions or tranches reflecting different degrees of credit risk. According to APS 120 paragraph 12(s), a warehouse SPV is a securitisation even if it does not have at least two different tranches of creditors or securities.
Materiality	Not material. According to APRA, all warehouse SPV structures include senior and subordinated pieces (ie there is tranching).
Basel paragraph no	Basel II paragraph 564
Reference in domestic regulation	APS 120 paragraphs 16, 24 and 25, APS 120 Attachment B paragraph 20 and 21
Findings	<p>Pursuant to Basel II paragraph 564, when a bank provides implicit support to a securitisation, it must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Furthermore, the bank is required to disclose publicly that (i) it has provided contractual support and (ii) the capital impact of doing so.</p> <p>Correspondingly, in regard to Pillar 2, Basel II paragraph 792 states that when a bank has been found to provide implicit support to a securitisation, it will be required to hold capital against all of the underlying exposures associated with the structure as if they had not been securitised. It will also be required to disclose publicly that it was found to have provided non-contractual support, as well as the resulting increase in the capital charge. The aim is to require banks to hold capital against exposures for which they assume the credit risk and to discourage them from providing non-contractual support.</p> <p>APRA has a different approach to dealing with implicit support. On the one hand, it explicitly prohibits the provision of implicit support in APS 120 paragraph 16. On the other hand, APS 120 paragraphs 24 and 25 grant APRA discretion on how to react in cases where an ADI has provided implicit support to a securitisation. Under APS 120 paragraph 24, APRA may increase the ADI's capital requirement by an amount specified by APRA which should be commensurate with the risks arising from the provision of the implicit support. In addition, APRA may increase the capital charge on all of the ADI's securitisation business. The granted discretion for APRA does not ensure that ADIs providing implicit support hold at minimum capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Furthermore, pursuant to APS 120 paragraph 25, APRA may require the ADI to publicly disclose the implicit support. Due to the granted discretion for APRA public disclosure of the implicit support and its capital impact is not ensured. This deviation also affects the implementation of Pillar 2 (Basel II paragraphs 791–794).</p>
Materiality	Not material. On the one hand, APRA has not in practice applied its discretion. Further it has prohibited implicit support and is in this regard super-equivalent to the Basel Framework. Moreover, it has illustrated that it has a history of impeding implicit support. On the other hand, the importance of combating implicit support is clearly highlighted in Pillar 1 and Pillar 2 of the Basel Framework by the introduction of minimum requirements in regard to the consequences that should be drawn if implicit support is detected. Due to APRA's risk-based approach the difference in the applied capital requirement might be significant, especially in minor cases of implicit support. Due to APRA's discretion in regard to the consequences of implicit support, it cannot be ruled out that APRA would apply milder consequences than the minimum requirements in the Basel Framework when

	implicit support is detected.
Basel paragraph no	Basel II paragraphs 569 and 570
Reference in domestic regulation	APS 120 paragraph 18, Attachment B paragraphs 2(d), 8, 29–30 and APG 120 paragraphs 25–27
Findings	<p>Pursuant to Basel II paragraph 569, only third-party investors, as opposed to banks that serve as originators, may recognise external credit assessments that are equivalent to BB+ to BB– for risk-weighting purposes of securitisation exposures. According to Basel II paragraph 570, originating banks must deduct all retained securitisation exposures rated below investment grade (ie BBB–). Basel III paragraph 90 introduced a 1250% risk weight instead of deduction for securitisation exposures.</p> <p>APS 120 does not provide this treatment for originating ADIs. Thus, originating ADIs are also allowed to risk-weight securitisation exposures rated BB+ to BB– at 350% instead of the 1250% as detailed in Basel III paragraph 90.</p>
Materiality	<p>Not material. According to APRA, there are no ADIs using the standardised approach to securitisation reporting below investment grade exposures at 350% risk weight. An originating ADI may (i) acquire securitisation exposures with a rating below investment grade and (ii) meet the requirements for the significant credit risk transfer. However, mitigating factors are: APS 120 Attachment F paragraph 8 restricts the acquisition by an originating ADI of securities issued by the SPV (at arm’s length, no disproportionate levels). Moreover, APG 120 paragraphs 25 and 26 provide guidance as to APRA’s interpretation of significant credit risk transfer. Under APG 120 paragraph 25 APRA believes it would be difficult to justify a significant credit risk transfer if an ADI held the majority of the lower grades of securities issued by the SPV particularly where there is not a first loss credit enhancement tranche in place that absorbs losses from all sources. According to APG 120 paragraph 26, originating ADIs holding the most subordinated tranches of a securitisation have retained a substantial majority of the credit risk in the transaction. Moreover, Basel II paragraphs 569 and 570 deal only with the standardised approach for securitisation.</p>
Basel paragraph no	Basel II paragraph 590
Reference in domestic regulation	APS 120 paragraph 12(r) and Attachment G paragraph 2
Findings	<p>Pursuant to Basel II paragraph 590 an originating bank is required to hold capital against all or a portion of the investors’ interest when:</p> <p>It sells exposures into a structure that contains an early amortisation feature; and</p> <p>The exposures sold are of a revolving nature. These involve exposures where the borrower is permitted to vary the drawn amount and repayments within an agreed limit under a line of credit (eg credit card receivables and corporate loan commitments).</p> <p>Under APS 120 paragraph 12(r), revolving exposures are exposures arising from revolving (that is redrawable) facilities, other than exposures in the nature of redrawable home loans where the amounts likely to be redrawn in any collection period are expected to be immaterial relative to the size of the pool. Such an exception for redrawable home loans is not provided in Basel II paragraph 590(b).</p>
Materiality	<p>Not material. Basel II paragraph 590(b) only applies to early amortisation structures under the standardised approach to securitisation exposures. According to APRA housing loan securitisation structures in Australia do not contain early amortisation features.</p>
Basel paragraph no	Basel II paragraphs 594
Reference in domestic regulation	APS 120 Attachment B paragraph 25
Findings	<p>According to Basel II paragraph 594 for a bank using the standardised approach for securitisation exposures and subject to the early amortisation treatment, the total capital charge for all of its positions will be subject to a maximum capital requirement (ie a “cap”) equal to the greater of (i) that required for retained securitisation exposures, or (ii) the capital requirement that would apply had the exposures not been securitised. The Basel securitisation framework does not cap the capital requirement in regard to banks which use the standardised approach for securitisation exposures but which are not subject to the early amortisation treatment. The cap in Basel II paragraph 610 applies only to banks using the IRB approach to securitisation.</p> <p>In contrast, APS 120 Attachment B paragraph 25 allows all originating ADIs, including ADIs using the standardised approach for securitisation exposures which are not subject to the early amortisation treatment, to elect to treat the pool as if it is held on its books and risk-weight the exposures under APS 112 (Standardised Approach) or APS 113 (IRB Approach), as appropriate, rather than as a securitisation</p>

Materiality	Not material. The finding only affects ADIs using the standardised approach for securitisation exposures which are not subject to the early amortisation treatment. The impact on these ADIs is unlikely to be material.
Basel paragraph no	Basel II paragraph 608
Reference in domestic regulation	APS 120 Attachment C paragraph 1 and Attachment D paragraphs 1 and 39
Findings	Under Basel II paragraph 608, where there is no specific IRB treatment for the underlying asset type, originating banks that have received approval to use the IRB approach must calculate capital charges on their securitisation exposures using the standardised approach in the securitisation framework and investing banks with approval to use the IRB approach must apply the Ratings-Based Approach (RBA). APRA has not implemented this provision.
Materiality	Not material. Australia's internationally active ADIs use the IRB approach for all exposures that are typically securitised. According to APRA the amount of securitised assets for which no IRB treatment exists is negligible.
Basel paragraph no	Basel II paragraphs 609 and 619
Reference in domestic regulation	APS 120 Attachment D paragraph 2
Findings	Pursuant to Basel II paragraph 609, the RBA must be applied to securitisation exposures that are rated, or where a rating can be inferred. Where an external or an inferred rating is not available, either the Supervisory Formula Approach (SFA) or the Internal Assessment Approach (IAA) must be applied. The IAA is only available to exposures (eg liquidity facilities and credit enhancements) that banks (including third-party banks) extend to ABCP programmes. In contrast, APS 120 Attachment D paragraph 2 does not restrict the IAA to exposures that banks extend to ABCP programmes. Instead, subject to APRA's approval, the IAA could also be used for facilities that the ADI extends to another kind of securitisation, where the RBA and the SFA cannot be used.
Materiality	Not material. According to the impact assessment in regard to two affected ADIs in the sample, the impact is not material.
Basel paragraph no	Basel II paragraph 629
Reference in domestic regulation	APS 120 Attachment B paragraph 15 and Attachment D paragraph 35
Findings	Basel II paragraph 629 deals with the calculation of K_{IRB} . APS 120 Attachment B paragraph 15 and Attachment D paragraph 35 do not implement Basel paragraph 629 sentence 1, which requires that in cases where a bank has set aside a specific provision or has a non-refundable purchase price discount on an exposure in the pool, K_{IRB} must be calculated using the gross amount of the exposure without the specific provision and/or non-refundable purchase price discount.
Materiality	Not material. According to APRA it is well understood and applied in practice that the gross amount of the exposure without the specific provision and/or non-refundable purchase price discount must be calculated. APRA will rectify and is currently reviewing APS 120, with a view to issuing a new standard in 2015.

2.2.6 Counterparty credit risk framework

Section grade	Compliant
Summary	APRA's Prudential Standards are substantively in line with the Basel Framework for counterparty credit risk and central counterparties.
Basel paragraph no	95 of Annex 4: Current Exposure Method
Reference in domestic regulation	There is no corresponding requirement in APRA's prudential standards.
Findings	Basel paragraph 95 of Annex 4 states: "To determine capital requirements for hedged banking book exposures, the treatment for credit derivatives in this Framework applies to qualifying credit derivative instruments." APRA has acknowledged that its Prudential Standards do not contain this requirement. While the <i>explicit</i> standard has not been incorporated, APRA's requirements do appear to substantively address the operational criteria and other requirements for recognising the risk-reducing effects of credit derivatives more generally.
Materiality	Not material

Basel paragraph no	104 of Annex 4 as amended by Basel III: Standardised CVA risk capital charge
Reference in domestic regulation	APS 112 Attachment C paragraphs 4, 9, 10 and 13
Findings	Basel paragraph 104 of Annex 4 requires a bank that has not been approved to calculate an advanced CVA risk capital charge per paragraph 98 to calculate a CVA capital charge for its counterparties using a standardised formula. For an ADI with immaterial exposures to OTC derivatives, APRA has introduced a simplified CVA approach as an alternative to the Basel standardised CVA calculation approach whereby an ADI that applies for and receives permission from APRA to use the simplified approach must set its CVA risk capital charge equal to its counterparty credit default risk capital requirement. APRA may allow use of the simplified CVA approach where it is satisfied that the nature and scale of the ADI's OTC derivatives usage is such that the resulting counterparty credit risk exposures are not sufficiently material. APRA's analysis to date suggests that the simplified calculation is typically within 75–125% of the Basel standardised formula. An ADI with either funded or unfunded default fund contributions to a central counterparty may not use APRA's simplified CVA approach. Further, APRA has indicated that none of its internationally active ADIs have been or will be permitted to use APRA's simplified CVA approach.
Materiality	Not material

2.2.7 Market risk: Standardised Measurement Method

Section grade	Compliant
Summary	APRA's Prudential Standards are largely in line with the Basel Framework for measuring market risk under the standardised measurement method with a few exceptions as detailed below.
Basel paragraph no	Paragraph 16 (including footnote 3): Introduction – exclusions from the trading book
Reference in domestic regulation	There is no corresponding requirement in APRA's Prudential Standards
Findings	<p>APRA's Prudential Standards do not explicitly address the items specified in footnote 3 to Basel paragraph 16 (as amended by Basel 2.5) as being ineligible for inclusion in the trading book. More specifically, the footnote states (in part): "...it is the Committee's view that, at the present time, open equity stakes in hedge funds, private equity investments, positions in a securitisation warehouse and real estate holdings do not meet the definition of the trading book, owing to significant constraints on the ability of banks to liquidate these positions and value them reliably on a daily basis." APRA has indicated that while these items are not explicitly stated in APS 116, they would be excluded on the basis of APRA's eligibility requirements for the trading book definition (APS 116 Attachment A paragraph 4).</p> <p>As part of the Basel 2.5 revisions, the Basel Committee explicitly added "positions in a securitisation warehouse" to the items to be excluded from the definition of the trading book based on concerns that some banks had been including such positions in the trading book despite the liquidation and valuation challenges that can be associated with them. One could reasonably infer that the intent of specifically excluding the additional item (and the pre-existing items) from the definition of the trading book was to remove any potential ambiguity regarding the regulatory capital treatment of these items. Not specifying the items for exclusion from the trading book, therefore, could lead to inconsistent regulatory capital treatment of these items within an ADI and across ADIs. APRA is of the view that the correct application of APS 116 Attachment A paragraphs 4(b) (i)–(vi) should result in exclusion of the items in footnote 3 from an ADI's trading book. Based on data provided by APRA, the ineligible positions are not included in the sample ADIs' trading books with one minor exception whereby one ADI occasionally has had an immaterial position reflecting an open equity stake in a hedge fund for a brief period owing to the operation of the fund redemption and hedging process.</p>
Materiality	Not material
Basel paragraph no	685: Market risk – The risk measurement framework – Scope and coverage of the capital charges
Reference in domestic regulation	APS 116 paragraph 10 and Attachment A paragraphs 3, 4 and 11(g)
Findings	Basel paragraph 685 states (in part): "To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely." The language regarding "restrictive covenants" and

	<p>"hedged completely" does not appear in APS 116 Attachment A paragraphs 3 or 4. Paragraph 11(g) appears to focus on how an ADI addresses the extent of legal restrictions or other impediments to liquidation or hedging of an exposure in the ADI's trading book policy statement, but does not appear to limit inclusion of positions in the trading book on this basis.</p>
Materiality	Not material
Basel paragraph no	711(i) – 711(ii): Market risk – The risk measurement framework – Interest rate risk – Issuer risk ("qualifying" category)
Reference in domestic regulation	APS 116 Attachment B paragraphs 7–9
Findings	<p>Regarding whether a position can be included in the "qualifying" category for purposes of determining specific risk capital requirements, APS 116 Attachment B paragraph 7(b) does not clearly include the full provision in the second bullet of Basel paragraph 711(i), which states "<u>rated investment-grade by one rating agency and not less than investment-grade by any other rating agency specified by the national authority (subject to supervisory oversight); or...</u>" (emphasis added).</p> <p>Rather, APS 116 Attachment B paragraph 7(b) states "<u>rated investment grade by one ECAI or unrated, but deemed, subject to APRA's written approval, to be of comparable investment quality by the ADI and the issuer has its equity included in a recognised market index (refer to Table 8). An ADI must apply to APRA for approval of a policy statement outlining securities the ADI considers to be of comparable investment quality</u>" (emphasis added).</p> <p>APRA has indicated that it interprets the wording of APS 116 Attachment B paragraph 7(b) to mean that APRA's written approval is required for including either of the following in the "qualifying" category: securities with only one rating (investment grade) or unrated. In either case only securities with equity included on a recognised market index would (if approved) be allowed to be categorised as "qualifying". However, as written, APRA's language regarding written approval is unclear and could be interpreted by some as pertaining only to unrated securities. Thus, the language could be read to allow a security to be included in the "qualifying" category for specific risk capital requirements in cases where the security has only two ratings, one investment grade and one non-investment grade. This could lead to an underestimation of specific risk capital requirements for securities that should be included in the "other" category, which is subject to higher capital requirements. Based on data provided by APRA, four out of the five ADIs in the sample have not included positions in the "qualifying" category that have only two ratings – one investment grade and one non-investment grade. One ADI in the sample has included one immaterial (less than \$450,000 notional) index position with these characteristics in the "qualifying" category, but had not sought APRA's approval to do so. APRA noted that the contact at this ADI had some interpretive difficulties with the paragraph in question and has agreed to reclassify this exposure in the "other" category.</p>
Materiality	Not material
Basel paragraph no	718(x) inclusive of footnote: Market risk – The risk measurement framework – Interest rate risk – Interest rate derivatives
Reference in domestic regulation	There is no corresponding requirement in APS 116.
Findings	<p>The footnote to Basel paragraph 718(x) states: "For instruments where the apparent notional amount differs from the effective notional amount, banks must use the effective notional amount." APRA has acknowledged that APS 116 does not contain the provision in the Basel footnote, but is unaware of any instruments currently traded for which the effective notional amount would exceed the apparent notional amount.</p>
Materiality	Not material
Basel paragraph no	718(xxvii): Market risk – Equity position risk – Calculation of positions and capital charges
Reference in domestic regulation	APS 116 Attachment B paragraphs 47–55 and Table 8
Findings	<p>Basel paragraph 718(xxvii) states (in part) the following:</p> <p>"Where a bank engages in a deliberate arbitrage strategy, in which a futures contract on a broadly based index matches a basket of stocks, it will be allowed to carve out both positions from the standardised methodology on condition that:</p> <p>The trade has been deliberately entered into and separately controlled;</p> <p>The composition of the basket of stocks represents at least 90% of the index when broken down into its notional components."</p> <p>To the end of the last bullet point above, APS 116 Attachment B paragraph 53(b) adds (in</p>

	part): "or a minimum correlation between the basket of shares and the index of 0.9 can be clearly established over a minimum period of one year. An ADI wishing to rely on the correlation-based criteria will need to satisfy APRA of the accuracy of the method chosen." The Basel Framework does not provide for this condition. APRA has indicated that this provision was provided as an alternative pragmatic approach to the Basel provision, noting that the Basel metric (% of index) may not always be the best measure of arbitrage effectiveness. Use of APRA's alternative approach by an ADI would require APRA's approval. APRA is not aware of any cases where such approval was requested or granted. Further, the provision is not used in practice and may be considered a legacy matter.
Materiality	Not material

2.2.8 Market risk: Internal Models Approach

Section grade	Compliant
Summary	APRA's Prudential Standards are substantively in line with the Basel Framework for the Internal Models Approach for market risk.

2.2.9 Operational risk: Basic Indicator Approach and the Standardised Approach

Section grade	Compliant
Summary	No significant deviations were identified by the RCAP Team. APRA has not implemented the BIA. However this is not considered to be a deviation as a more advanced approach (the SA) has been adopted as the minimum standard. APRA has exercised the discretion of implementing the alternative standardised approach to operational risk. APRA has not implemented the qualifying criteria (Basel II paragraph 660) nor the initial monitoring (Basel II paragraph 661) for the application of the SA as this is in fact the default minimum approach in Australia. However, the forthcoming risk management standard CPS 220 (effective from 1 January 2015) will incorporate similar requirements.
Basel paragraph no	Paragraph 660 :The Standardised Approach – Qualifying Criteria
Reference in domestic regulation	CPS 220 paragraphs 12, 20–26
Findings	The qualifying criteria for the standardised approach to operational risk were not considered necessary as APRA has adopted it as the default minimum standard for determining regulatory capital for operational risk. Therefore there is no mention of qualifying criteria in APS 114. Notwithstanding the forthcoming risk management standard, CPS 220 will incorporate (with a somewhat different wording) the Basel II qualifying requirements. However CPS 220 will not be fully effective until 1 January 2015.
Materiality	Not material
Basel paragraph no	Paragraph 661 (initial monitoring)
Reference in domestic regulation	NA
Findings	Initial monitoring not required as use of SA as a minimum standard is mandatory.
Materiality	Not material

2.2.10 Operational risk: Advanced Measurement Approaches

Section grade	Compliant
Summary	No significant deviations were identified by the RCAP Team. In June 2011, APRA removed the Basel I capital floor. Notwithstanding, the ADIs using the AMA to operational risk remain well above the 80% Basel 1 floor.
Basel paragraph no	Paragraph 659 (AMA – capital floor)
Reference in domestic regulation	APS 110 Attachment A paragraph 4 and attachment paragraph 1

Findings	APRA removed the Basel I capital floor in June 2011 for ADIs using the AMA so transitional arrangements (paragraphs 659 and 46) are no longer in place. These ADIs remain well above the 80% Basel I floor.
Materiality	Not material

2.3 Pillar 2: Supervisory review process

Section grade	Compliant
Summary	<p>The central element of APRA's framework for prudential supervision is the entity risk assessment. Entity risk assessments are completed using APRA's PAIRS tool. The main objectives of a PAIRS assessment are to estimate the probability that an ADI will fail and to measure the impact of the potential consequences of that failure. A PAIRS rating brings together APRA's assessment of the key risks, management, controls and capital support for an ADI which in turn, guides its supervisory action plan. APRA's supervisory actions are driven by its Supervisory Oversight and Response System (SOARS). APRA's four supervision stances are:</p> <ul style="list-style-type: none"> • Normal; • Oversight; • Mandated Improvement; and • Restructure. <p>Under APS 110, APRA has the power to increase capital requirements and restrict capital reductions. In particular, APRA may determine a Pillar 2 supervisory adjustment, such as requiring an ADI to meet a prudential capital requirement greater than the minimum levels of the Basel Framework. Furthermore, the Banking Act confers on APRA a comprehensive set of powers to ensure ADIs comply with regulatory and prudential requirements and to address emerging concerns about an ADI's safety and soundness. In particular, APRA has wide powers of direction. For instance, APRA may give an ADI a direction to comply with prudential standards or a direction to arrange an independent audit or to restrict payment of dividends, or other amounts on shares. APRA also has the power to issue a recapitalisation direction under Section 13E.</p>
Basel paragraph no	Basel II paragraph 738(v)
Reference in domestic regulation	There is no corresponding domestic regulation
Findings	Under Basel II paragraph 738(v) banks must demonstrate how they combine their risk measurement approaches to arrive at the overall internal capital for market risk. APRA has not included this provision in its Prudential Standards.
Materiality	Not material. All internationally active ADIs have accredited VaR models and all but one of these base their internal market risk capital on that model. For these ADIs, there is an explicit requirement that they independently review their risk measurement systems on a regular basis and part of this review covers the process used to produce the calculation of market risk capital, which should include how they combine their different risk measurement approaches – see APS 116 Attachment C para 16(m). For the one ADI that bases its internal capital for market risk on a model other than its VaR model, APRA has sought information on the basis of aggregation of that (stress test-based) approach.
Basel paragraph no	Basel II paragraphs 791 to 794
Reference in domestic regulation	APS 120 paragraphs 24, 25 and 26
Findings	Basel II paragraphs 791 to 794 deal with the treatment of implicit support in the supervisory review process. Overall, the granted discretion for APRA in APS 120 paragraphs 24 and 25 does not ensure that banks providing implicit support hold at minimum capital against all of the exposures associated with the securitisation transaction as if they had not been securitised and that banks properly disclose the implicit support and its capital impact (see finding in regard to Basel II paragraph 564).
Materiality	Not material. Potential impact is already considered in the assessment in regard to Basel II paragraph 564.
Basel paragraph no	Basel II paragraph 795
Reference in domestic regulation	No corresponding domestic regulation

Findings	Basel II paragraph 795 demands that supervisors will review the appropriateness of protection recognised against first loss credit enhancements. Where supervisors do not consider the approach to protection recognised is adequate, they will take appropriate action, which may include increasing the capital requirement against a particular transaction or class of transactions.
Materiality	Not material. According to APRA this is subject to supervisory review and use of CRM for securitisation exposures is not a common practice in Australia.
Basel paragraph no	Supplemental Pillar 2 Guidance paragraphs 88–94 (Sound compensation practices)
Reference in domestic regulation	CPS 510 paragraphs 42–63. PPG 511
Findings	Implementation by APRA in CPS 510 of SP2G on sound compensation practices is somewhat vague and does not always provide ADIs with specific guidance. On some items PPG 511 provides ADIs with further guidance.
Materiality	Not material

2.4 Pillar 3: Market discipline

Section grade	Compliant
Summary	APRA has omitted to implement some parts of Basel II Table 8 (General disclosure for exposures related to counterparty credit risk) and Table 11 (Market risk: disclosures for banks using the internal models approach for trading portfolios). In spite of these oversights, disclosures by Australian ADIs are generally satisfactory. Moreover, the relatively small scale of Australian ADIs' market risk exposures limits the impact of the omissions. Lastly, it is expected that APRA will rectify the oversights in APS 330 by end-2014.
Basel paragraph no	Paragraph 812 (achieving appropriate disclosure)
Reference in domestic regulation	APS 330
Findings	There is no explicit mention in APS 330 of the direct sanction for not achieving appropriate disclosure (not being allowed to apply the lower weighting or the specific methodology) prescribed by paragraph 812. Notwithstanding this omission, compliance with APS 330 is mandatory and non-compliance would likely result in specific supervisory remedial action by APRA, obviating the need to disallow the use of lower risk weighting or a specific methodology.
Materiality	Not material
Basel paragraph no	Table 8 – General disclosure for exposures related to counterparty credit risk
Reference in domestic regulation	APS 330 Table 11
Findings	In APS 330, Attachment D, Table 11 APRA has omitted the "Quantitative disclosure" part of Basel II Table 8 as well as the related footnotes. However this omission relates to a small proportion of the Australian ADIs' credit exposures. As above mentioned, APRA will rectify this by end-2014.
Materiality	Not material
Basel paragraph no	Table 11 – Market risk: disclosures for banks using the internal models approach (IMA) for trading portfolios
Reference in domestic regulation	APS 330 Attachment D Table 14
Findings	APRA has omitted some parts of Basel II Table 11 in APS 330 Attachment D Table 14: the second sentence of (a) and (b) is missing. However, IMA ADIs' public disclosures are broadly satisfactory in this respect. As above mentioned, APRA will rectify this by end-2014.
Materiality	Not material
Basel paragraph no	Paragraph 30 Disclosure requirements for capital
Reference in domestic regulation	APS 330 paragraphs 9 and 31 and Attachment B

Findings	Basel paragraph 30 bullet point 2 states that banks are required to report each regulatory capital instrument, including common shares, in a separate column of the template, such that the completed template would provide a "main features report" that summarises all of the regulatory capital instruments of the banking group. ¹³
Materiality	Not material

¹³ While not using the same words as the Basel Framework, the intent is reflected in paragraph 9, and paragraph 1 in Attachment B to APS 330. This APS states that Attachment B must be in the regulatory disclosures section in the ADIs website. APRA has inadvertently left out this requirement. In practice, APRA expects that ADIs will publish all APS 330 disclosures in their financial reports or include a link to the disclosures in the website. APRA also intends to amend this omission by end-2014.

Annex 2: Implementation of the Basel framework as of cut-off date

Overview of adoption of capital standards

Table 4

Basel III Regulation	Date of issuance by BCBS	Transposed in Australian rule	Date of implementation in Australia	Status
Basel II				
Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	June 2006	<i>Prudential Standards and Prudential Practice Guides</i>	1 January 2008	4
Basel 2.5				
Enhancements to the Basel Framework Guidelines for computing capital for incremental risk in the trading book Revisions to the Basel II market risk framework	July 2009	<i>Prudential Standards and Prudential Practice Guides</i>	1 January 2012	4
Basel III				
Basel III: A global regulatory framework for more resilient banks and banking systems – revised version	June 2011 (Consolidated version)	<i>Prudential Standards and Prudential Practice Guides</i>	1 January 2013	4
Pillar 3 disclosure requirements for remuneration	July 2011	<i>Prudential Standard</i>	30 June 2013	4
Treatment of trade finance under the Basel capital framework	October 2011	<i>Prudential Standards</i>	1 January 2013	4
Composition of capital disclosure requirements	June 2012	<i>Prudential Standard</i>	30 June 2013	4
Capital requirements for bank exposures to central counterparties	July 2012	<i>Prudential Standards and Prudential Practice Guides</i>	1 January 2013	4

Number and colour code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. For rules which are due for implementation as on 30 June 2012, the following colour code is used: **Green** = implementation completed; **Yellow** = implementation in process; **Red** = no implementation.

Annex 3: List of capital standards under the Basel framework used for the assessment

- (i) International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), June 2006
- (ii) Enhancements to the Basel II framework, July 2009
- (iii) Guidelines for computing capital for incremental risk in the trading book, July 2009
- (iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", Basel Committee press release, 13 January 2011
- (v) Revisions to the Basel II market risk framework: Updated as of 31 December 2010, February 2011
- (vi) Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)
- (vii) Pillar 3 disclosure requirements for remuneration, July 2011
- (viii) Treatment of trade finance under the Basel capital framework, October 2011
- (ix) Interpretive issues with respect to the revisions to the market risk framework, November 2011
- (x) Basel III definition of capital – Frequently asked questions, December 2011
- (xi) Composition of capital disclosure requirements: Rules text, June 2012
- (xii) Capital requirements for bank exposures to central counterparties, July 2012
- (xiii) Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee, July 2012
- (xiv) Basel III counterparty credit risk – Frequently asked questions, November 2011, July 2012, November 2012

Annex 4: Local regulations issued by APRA for implementing Basel capital standards

Domestic regulations	Name of the document, version and date
Domestic regulations implementing Basel II	<p>The following prudential standards, prudential practice guidance and guidelines implemented Basel II from 1 January 2008:</p> <p><i>Prudential Standard APS 110 Capital Adequacy (APS 110)</i> <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)</i> <i>Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)</i> <i>Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (APS 113)</i> <i>Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk (APS 114)</i> <i>Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk (APS 115)</i> <i>Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116)</i> <i>Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs) (APS 117)</i> <i>Prudential Standard APS 120 Securitisation (APS 120)</i> <i>Prudential Standard APS 150 Capital Adequacy: Basel II Transition (Advanced ADIs) (APS 150)</i> <i>Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information (APS 330)</i> <i>Guidelines on Recognition of an External Credit Assessment Institution (the ECAI guidelines)</i> <i>Prudential Practice Guide APG 112 Standardised Approach to Credit Risk (APG 112)</i> <i>Prudential Practice Guide APG 113 Internal Ratings-based Approach to Credit Risk (APG 113)</i> <i>Prudential Practice Guide APG 114 Standardised Approach to Operational Risk (APG 114)</i> <i>Prudential Practice Guide APG 115 Advanced Measurement Approaches to Operational Risk (APG 115)</i> <i>Prudential Practice Guide APG 116 Market Risk (APG 116)</i> <i>Prudential Practice Guide APG 117 Interest Rate Risk in the Banking Book (APG 117)</i> <i>Prudential Practice Guide APG 120 Securitisation (APG 120)</i></p>
Domestic regulations implementing Basel 2.5	<p>APRA implemented Basel 2.5 from 1 January 2012 through revisions to the following prudential standards and prudential practice guides:</p> <p>APS 111, APS 116, APS 120, APS 330, APG 116 and APG 120. Remuneration requirements were included in <i>Prudential Standard APS 510 Governance</i> (now CPS 510) and a new prudential practice guide, <i>Prudential Practice Guide 511 Remuneration</i> (APG 511), both of which applied from 1 April 2010.</p>
Domestic regulations implementing Basel III	<p>APRA implemented the Basel III capital framework from 1 January 2013 through revisions to the following prudential standards:</p>

	<p>APS 110, APS 111, APS 112, APS 113, APS 116 and APS 120. A new prudential standard, <i>Prudential Standard APS 001 Definitions</i> (APS 001) was introduced at the same time. Other consequential changes were made to prudential and reporting standards. The ECAI guidelines and two prudential practice guides, APG 112 and APG 113, were also updated.</p> <p><i>Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review</i> (CPG 110) was released in March 2013.</p> <p>APS 330 was revised and renamed <i>Prudential Standard APS 330 Public Disclosure</i> and came into effect from 30 June 2013.</p> <p>A new prudential standard, <i>Prudential Standard CPS 220 Risk Management</i> (CPS 220), is due to commence on 1 January 2015.</p>
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Hierarchy of Australian laws and regulatory instruments

Table 6

Level of rules (in legal terms)	Type
Laws	Enacted by the Parliament of Australia.
Regulations	Regulations made under the <i>Banking Act 1959</i> are issued by the Governor-General on the recommendation of the Treasurer subsequent to the Treasurer's consultation with APRA.
Prudential standards	Issued by APRA.
Administrative instruments (eg conditions on banking authorities, directions)	Issued by APRA.
Other regulatory documents (prudential practice guides, other guidance and letters to industry)	Issued by APRA.

Annex 5: Details of the RCAP assessment process

A. Off-site evaluation

- (i) Completion of a self-assessment questionnaire by APRA
- (ii) Evaluation of the self-assessment by the RCAP Assessment Team
- (iii) Independent comparison and evaluation of the domestic regulations issued by APRA with corresponding Basel III standards issued by the BCBS
- (iv) Identification of observations
- (v) Refinement of the list of observations based on clarifications provided by APRA
- (vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment
- (vii) Forwarding of the list of observations to APRA

B. On-site assessment

- (viii) Discussion of individual observations with APRA
- (ix) Meeting with selected Australian banks, accounting firms and a credit ratings agency
- (x) Discussion with APRA and revision of findings to reflect additional information received
- (xi) Assignment of component grades and overall grade
- (xii) Submission of the detailed findings to APRA with grades
- (xiii) Receipt of comments on the detailed findings from APRA

C. Review and finalisation of the RCAP report

- (xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to APRA for comments
- (xv) Review of APRA's comments by the RCAP Assessment Team
- (xvi) Reporting of findings to SIG by the team leader
- (xvii) Review and clearance of the draft report by the RCAP Peer Review Board

Annex 6: List of items that APRA intends to amend in the near future

During the RCAP review, the Assessment Team noted some items in APRA's prudential standards that, while differing from the Basel standards, have in most cases no material or practical effect. APRA has indicated its intent to correct these oversights over the next one to two years. Further detail about each of these findings can be found in the detailed assessment within Section 2.

Basel Paragraph	Reference to APRA document and paragraph	Brief description of the forthcoming correction
Definition of Capital		
Basel III paragraphs 69–70	APS 111 Attachment D paragraphs 22 and 23	APRA's standards do not state that the deferred tax liabilities permitted to be netted against deferred tax assets must exclude amounts that have been netted against the deduction of goodwill, intangibles, and defined benefit superannuation assets (Basel III paragraph 69). APRA intends reviewing APS 111 in 2014 and will then rectify this oversight.
Basel III paragraph 75	APS 111 Attachment D paragraph 26	APRA's standards do not include with regard to derivative liabilities that all accounting valuation adjustments arising from the bank's own credit risk must be derecognised and that the offsetting between valuation adjustments arising from the bank's own credit risk and those arising from its counterparties' credit risk is not allowed. According to APRA, the requirement is applied in practice and it was just missed due to the later publication by Basel. APRA will amend the standard for this incorporation.
Basel III paragraphs 131, 147 and 148	APS 110 Attachment B paragraph 1	The minimum capital conservation ratio according to the table in APS 110 Attachment B paragraph 1 for an ADI with a CET1 ratio of 5.125% and CET1 prudential capital requirement of 4.5% would be 80%, whereas according to the table of Basel III paragraph 131 it would be 100%. According to APRA this is an unintended outcome and reflects the unintended omission of the "less than or equal" symbol in the printed text in Table 1 of Attachment B of APS 110. APRA will seek to correct when APS 110 is next amended, which will be before the capital conservation comes into effect.
Basel III paragraphs 132(a)–(b)	APS 110, paragraph 27, Attachment B paragraphs 3–4	With reference to the conservation buffer, Basel III stipulates where a bank does not have positive earnings and has a CET1 ratio less than 7%, it would be restricted from making positive net distributions. APRA has stated that this provision was inadvertently missed and will be corrected in the next revision of APS 110 over the next one to two years.
Basel III paragraph 149	APS 330, paragraph 9 and Attachment A, Table 1, item 64	APS 110 does not explicitly say that the buffer should be based on the latest relevant jurisdictional countercyclical buffers that are available at the date they calculate their minimum capital requirement. APRA expects APS 330 will be reviewed to incorporate this requirement over the next one to two years.
Credit risk: Standardised Approach		
Basel II paragraph 60	APS 112, Attachment A, item 9	APS 112 does not include the sovereign floor whereby no claim on an unrated bank may receive a risk weight lower than that applied to claims on its sovereign of incorporation. APRA will correct this.
Basel II paragraph 82	APS 112, Attachment B, paragraph 10	APRA standards do not include the statement regarding counterparty risk weightings for OTC derivative transactions will not be subject to any specific ceiling. APRA will rectify.

Credit risk: Internal Ratings-Based approach		
Basel II paragraph 229	APS 113, paragraph 44	APRA's IRB Prudential Standard has a wider definition (than Basel) as to PSE exposures that may be treated in an equivalent manner to sovereign exposures. APRA has indicated that this is a drafting oversight (with no practical implications) and the Prudential Standard will be revised to correct this.
Credit risk: Securitisation Framework		
Basel II paragraph 629	APS 120, Attachment B, paragraph 15; Attachment D, paragraph 35	Although it is well understood and applied in practice, APS 120 does not require that in cases where a bank has set aside a specific provision or has a non-refundable purchase price discount on an exposure in the pool, K_{IRB} must be calculated using the gross amount of the exposure without the specific provision and/or non-refundable purchase price discount. APRA will rectify.
Market risk		
Basel II paragraph 16 (including footnote 3)		APRA has indicated that it will provide further information to assist in identifying positions to exclude, such as the items in footnote 3, when viewing the policy framework for market risk as part of the fundamental review of the trading book currently being undertaken by the BCBS.
Operational risk		
Basel paragraph 660	APS 114 and future CPS 220 paragraphs 12, 20-26	The qualifying criteria for the standardised approach to operational risk are not explicitly mentioned in APS 114. Notwithstanding this, the risk management standard CPS 220, which will come into place in January 2015, incorporates the Basel II qualifying requirements.
Pillar 3		
Basel paragraph 30	APS 330 paragraphs 9 and 31 and Attachment B	APRA has inadvertently not required ADIs to include Attachment B in the published reports or a link to the disclosure. APRA intends amending this omission by end-2014.
Table 8	APS 330 Table 11	APRA has omitted the "Quantitative disclosure" part of Basel II Table 8 as well as the related footnotes. APRA intends rectifying this by end-2014.
Table 11	APS 330 Attachment D Table 14	APRA has omitted some parts of Basel II Table 11 in APS 330 Attachment D Table 14: the 2nd sentence of (a) and (b) are missing. APRA intends rectifying this by end-2014.

Annex 7: Assessment of binding nature of regulatory documents issued by APRA

The following table summarises the assessment of the seven criteria used by the Assessment Team to determine the eligibility of APRA's regulatory documents. The team concluded the regulatory documents issued by APRA are eligible for the RCAP assessment.

Criterion	Assessment
The instruments used are part of a well defined, clear and transparent hierarchy of legal and regulatory framework.	<p>The Banking Act provides the overarching legal framework regulating banking business in Australia. The Banking Act empowers APRA to grant authorities to carry on banking business to ADIs and to authorise non-operating holding companies (authorised NOHCs).</p> <p>Section 11AF of the Banking Act delegates to APRA the power to make legally enforceable standards in relation to prudential matters, including measures to keep an ADI, authorised NOHC, group or group member/s in a sound financial position (Prudential Standards). Prudential Standards that apply to more than one specific ADI or authorised NOHC are legislative instruments, which means that they must be tabled in the Australian Parliament and are subject to a period of disallowance. The Basel II, 2.5 and III capital framework has been implemented by APRA through Prudential Standards made under the power conferred on APRA in Section 11AF of the Banking Act.</p> <p>An integral component of APRA's prudential framework are prudential practice guides (PPGs). The PPGs relating to capital are inextricably linked to the relevant Prudential Standards. They provide interpretation of the requirements set out in the prudential standards and detail best practice, adoption of which enables ADIs to demonstrate (to APRA) compliance with the Prudential Standards.</p>
(2) They are public and easily accessible	<p>APRA publishes its Prudential Standards and PPGs on its website.</p> <p>Prudential standards that are legislative instruments, including those implementing the Basel capital framework, are required to be lodged on the Federal Register of Legislative Instruments (FRLI) and are available on the ComLaw website at www.comlaw.gov.au.</p>
(3) They are properly communicated and viewed as binding by banks as well as by the supervisors.	<p>As legislative instruments made pursuant to powers under the Banking Act, Prudential Standards must be complied with by the ADIs and/or authorised NOHCs to which they apply. APRA consults widely on its proposed implementation of prudential standards.</p> <p>PPGs provide interpretation of the requirements set out in the Prudential Standards and detail best practice, adoption of which enables ADIs to demonstrate (to APRA) compliance with the Prudential Standards. In performing its supervisory role, APRA takes account of the regard given by ADIs and authorised NOHCs to the PPGs. APRA may, for example, impose an additional capital requirement where it considers a PPG has been ignored at the expense of sound prudential practice. As a measure of their standing in APRA's prudential framework, APRA adopts the same level of consultation in drafting the PPGs as it does for the Prudential Standards.</p>
(4) They would generally be expected to be legally upheld if challenged and are supported by precedent.	<p>Prudential Standards (and other measures) applying capital requirements have been in place since APRA's establishment in 1998. No legal challenges have been made to them. APRA expects that its Prudential Standards implementing Basel II, 2.5 and III would be upheld if challenged.</p>
(5) Consequences of failure to comply are properly understood and carry the same practical effect as for the primary law or regulation.	<p>As Prudential Standards are delegated legislation, the consequences of failure to comply with their requirements are widely known and accepted. In the event of non-compliance with whole or part of a Prudential Standard, APRA may issue a direction under Section 11CA of the Banking Act to an ADI or authorised NOHC to comply. Failure by an ADI or authorised NOHC to comply with a direction constitutes a criminal offence under Section 11CG of the Banking Act. An officer of an ADI or authorised NOHC may also be convicted of a criminal offence should the officer fail to take reasonable steps to ensure the ADI or authorised NOHC complies with the direction, and the officer's duties include ensuring that the ADI or authorised NOHC complies.</p> <p>With respect to the consequences of failure to have regard to PPGs, refer to Criterion 3.</p>
(6) The regulatory provisions are expressed in clear language that complies with the Basel provisions	<p>Prudential Standards are expressed to strike a balance between clarity and enforceability, including imposing mandatory requirements (eg an ADI "must" do or not do something). APRA seeks to ensure compliance with the Basel rules texts using Basel language where</p>

<p>in both substance and spirit.</p>	<p>appropriate, tailored to take account of local terminology, existing prudential requirements and accommodating efforts to harmonise prudential requirements across the insurance and banking sectors.</p> <p>PPGs provide interpretative guidance and an outline of best practice. Given the nature of these documents, words such as “it is APRA’s view that”, “best practice”, “good practice” or “a prudent ADI would take this action” are used.</p>
<p>(7) The substance of the instrument is expected to remain in force for the foreseeable future</p>	<p>APRA has responsibility for making, varying and revoking Prudential Standards and fully intends that they will remain in force for the foreseeable future.</p>

Annex 8: Key financial indicators of Australian banking system

Overview of Australia banking sector as of 31 March 2013

Table 7

Size of banking sector (AUD billions) ¹⁵	
Total assets all ADIs operating in the jurisdiction (including off-balance sheet assets)	4,225
Total assets of all locally incorporated internationally active ADIs	3,564
Total assets of locally incorporated ADIs to which capital standards under Basel framework are applied (ie excludes foreign bank branches)	3,958
Number of ADIs	
Number of ADIs operating in Australia	165
Number of internationally active ADIs	5
Number of ADIs required to implement Basel standards (according to domestic rules)	125
Number of global systemically important banks (G-SIBs)	0
Number of domestic systemically important banks (D-SIBs)	4
Capital standards under the Basel framework	
Number of ADIs required to implement Basel equivalent standards	125
Use of advanced approaches by ADIs	See Table 1
Capital adequacy (internationally active ADIs) (AUD billions; percent)	
Total capital	160
Total Tier 1 capital	139
Total CET1 capital	112
Total risk-weighted assets	1,357
RWAs for credit risk (percent of total RWAs)	85.2%
RWAs for market risk (percent of total RWAs)	5.6%
RWAs for operational risk (percent of total RWAs)	9.2%
Total off-balance sheet bank assets ¹⁶	769
Capital adequacy ratio (weighted average)	11.8%
Tier 1 Ratio (weighted average)	10.2%
CET1 Ratio (weighted average)	8.3%

Source: APRA, data as of March 2013.

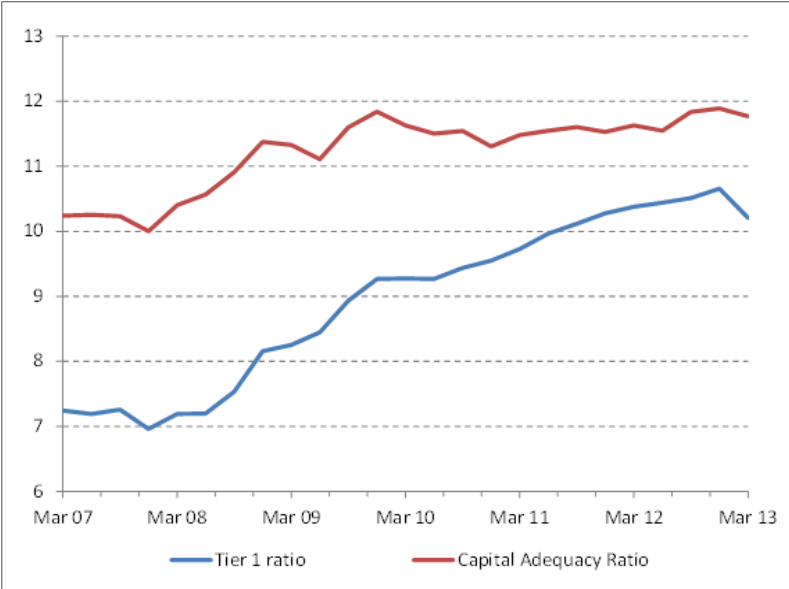
¹⁵ This does not include authorised non-operating holding companies, specialist credit card providers, providers of purchased payment facilities and "other ADIs": refer to www.apra.gov.au/adi/Pages/adilist.aspx.

¹⁶ This includes derivatives at fair value and the credit equivalent amount of non-market-related off-balance sheet exposures.

Evolution of capital ratios of Australian internationally active banks

Weighted average, in percent

Figure 1



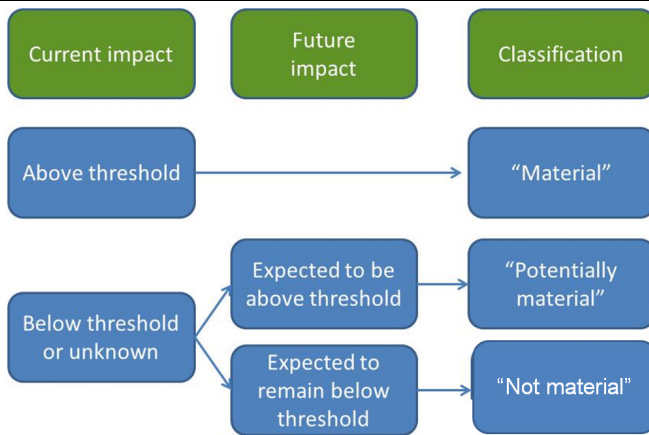
Source: APRA.

Annex 9: Materiality assessment

The assessment of materiality distinguished between quantifiable and non-quantifiable gaps. For the Australia RCAP, an attempt was made to quantify the impact of all quantifiable gaps for each bank in the sample affected by the gap. In total, 59 gaps/differences were assessed based on bank data and data available to APRA. In those cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data were available to quantify gaps, the review team relied on expert judgment. Following this approach, an attempt was made to determine whether gaps are “not material”, “material” or “potentially material”.

Classification of quantifiable gaps

Figure 2



Number of gaps / differences by component

Table 8

Component	Non-material	Material	Potentially material
Scope of application	3	0	0
Transitional arrangements	0	0	0
Definition of capital	9	2	0
Capital buffers	4	0	0
Pillar 1			
Minimum capital requirements (general)	1		
CR: Standardised Approach	9	0	0
CR: IRB	3	1	1
CR: Securitisation	9	0	0
Counterparty credit risk	2	0	0
MR: Standardised approach	5	0	0
MR: Internal Models	0	0	0
OR: SA/BIA	2	0	0
OR: AMA	1	0	0
Pillar 2	4	0	0
Pillar 3	4	0	0

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps). See Section 2 with the detailed assessment findings for further information.

Annex 10: Areas where APRA's rules are stricter than the Basel minimum standards

In several places, APRA has adopted a stricter approach than the minimum standards prescribed by Basel or has simplified or generalised an approach in a way that does not necessarily result in stricter requirements under all circumstances but never results in less rigorous requirements than the Basel standards. The following list provides an overview of these areas, which was put together with the help of APRA. It should be noted that these areas have not been taken into account as mitigants for the overall assessment of compliance.

Definition of capital and transitional arrangements

1. Basel III paragraph 67

Basel requires exposures classified as intangible assets under International Financial Reporting Standards to be deducted from Common Equity Tier 1 (CET1) capital. In addition to these exposures, APRA requires the deduction from CET1 capital of certain other items which APRA deems should be treated in a similar fashion to intangibles (for example, capitalised expenses, capitalised transaction costs and mortgage servicing rights).

2. Basel III paragraph 78

Basel requires that banks deduct investments in own shares (treasury stock) from CET1 capital. APRA also requires the deduction of any unused portion of any trading limits in own shares that have been agreed with APRA.

3. Basel III paragraph 79

Basel requires reciprocal cross-holdings in the capital of banking, financial and insurance entities to be deducted from CET1 capital. APRA requires the full deduction of all holdings of capital of banking, financial and insurance entities, regardless of whether they are reciprocal.

4. Basel III paragraphs 80–81

Basel does not require the deduction of the aggregate amount of investments in the capital of banking, financial and insurance entities in which the bank owns less than 10% of the issued share capital of each entity where this (aggregate) amount is less than 10% of the bank's adjusted CET1 capital. APRA requires the full amount of such investments to be deducted from CET1 capital.

5. Basel III paragraphs 87–89

APRA did not adopt the threshold deduction approach for deferred tax assets for temporary differences, significant investments in unconsolidated financial entities and mortgage servicing rights. Instead, these exposures must be deducted in full from CET1 capital.

6. Basel III paragraphs 94(a)–(g)

APRA did not provide transition for the Basel III minimum capital ratios, regulatory adjustments (deductions) or the treatment of minority interest and other capital held by third parties. These requirements came into effect on 1 January 2013.

7. Basel III paragraphs 95–96

Basel details transitional arrangements for capital instruments issued before 1 January 2013. APRA had more stringent transitional arrangements for capital instruments issued before this date.

8. Basel III paragraphs 133–135 and 150

APRA will not implement the transitional arrangements for the capital conservation and countercyclical capital buffers. Authorised deposit-taking institutions (ADIs) will be required to meet these in full from 1 January 2016.

Credit risk: Standardised Approach

9. Basel II paragraph 71

APRA did not adopt the 75% risk weight for retail exposures; such exposures are risk-weighted at 100%.

10. Basel II paragraph 73

Basel allows claims secured by residential property to be risk-weighted at 35%. APRA introduced a residential mortgage risk-weight matrix whereby the risk weights for exposures secured by residential property range from 35% to 100%.

11. Credit risk mitigation

Basel II credit risk mitigation techniques would generally result in a minimal capital charge for margin lending exposures. Instead, APRA has set a 20% risk weight for margin lending exposures secured by listed instruments on recognised exchanges (unless subject to deduction under APS 111). Otherwise (eg where the underlying instruments are unlisted) the ADI must treat the exposure as a secured loan (unless subject to deduction under APS 111).

Credit risk: Internal Ratings-Based approach

12. Basel II paragraphs 215

Under the Basel internal ratings-based (IRB) approach, banks must categorise banking book exposures into five broad asset classes: (a) corporate, (b) sovereign, (c) bank, (d) retail and (e) equity. APRA does not include margin lending exposures in these IRB portfolios. The risk weights for such exposures are the same as under APRA's standardised approach (refer to item 11 above). This results in a considerably higher capital charge than would be expected under the Basel IRB treatment.

13. Basel II paragraph 232

Basel II set a threshold of EUR 1 million for small business exposures to be included in the retail portfolio. APRA converted this threshold to Australian dollars on a 1:1 basis (effectively setting a lower threshold).

14. Basel II paragraph 234

Basel II sets the maximum exposure to a single individual in the qualifying revolving retail sub-portfolio at EUR 1 million. APRA converted this threshold to Australian dollars on a 1:1 basis (effectively setting a lower threshold).

In addition, APRA does not allow exposures for business purposes to be included in the qualifying revolving retail portfolio. Such (otherwise qualifying) exposures fall into the other retail portfolio (or possibly the corporate portfolio), which results in a higher capital requirement.

15. Basel II paragraph 273

The Basel II firm size adjustment for small- and medium-sized entities that are risk-weighted on the corporate curve cuts out for firms with turnover above EUR 50 million. APRA converted this threshold to Australian dollars on a 1:1 basis (effectively setting a lower threshold).

16. Basel II paragraph 295 (and 521–522)

Although Basel II allows other collateral to be recognised under the foundation IRB approach, APRA does not recognise other collateral in these circumstances. Under APRA's standards, if collateral does not meet the requirements for eligible financial collateral, financial receivables or residential or commercial real estate, the exposure must be considered unsecured and assigned a higher loss-given-default estimate under the foundation IRB approach.

17. Basel II paragraph 312 (and 366–367 for purchased receivables)

Under the foundation IRB approach, banks may assign a 75% credit conversion factor for commitments, note issuance facilities and revolving underwriting facilities. APRA has set the standard supervisory credit conversion factor to 100% for such exposures.

18. Basel II paragraphs 384–385 (and 43)

Banks must compare the total amount of eligible provisions with a total expected loss amount. Where the expected loss amount is less than the provision amount, Basel says that the difference may be included in Tier 2 capital subject to supervisors' satisfaction that the bank's expected loss fully reflects the conditions in the market. APRA is arguably more conservative in that prohibits any excess provision related to defaulted exposures to be included in Tier 2 capital.

Credit risk: securitisation

19. Basel II paragraph 543

Basel defines an originating bank as one that directly or indirectly originates exposures in the securitisation or one that sponsors an asset-backed commercial paper conduit or similar program that acquires exposures from third-party entities. APRA's definition is wider and includes ADIs that manage non-asset-backed commercial paper structures as the definition of origination is not dependent on the structure of the securitisation but rather on the ADI's role.

20. Basel II paragraph 554(f)

Basel defines implicit support (which is prohibited). APRA goes beyond the Basel definition and also prohibits an increase in yield as a result of changes in the credit rating of the originator.

Operational risk: Advanced Measurement Approaches

21. Basel II paragraphs 656

Basel allows foreign bank subsidiaries to use the parent bank's allocation mechanism for the purpose of determining the regulatory capital requirement for operational risk at that level if the host regulator accepts the mechanism. APRA has set out detailed conditions and criteria a foreign bank subsidiary must satisfy before its allocation mechanism is recognised for regulatory capital purposes. This includes requirements around sufficiency of allocated capital, appropriate risk-sensitivity of the allocation mechanism, controls on data and governance and the operational risk management framework aligning to the Advanced Measurement Approaches (AMA) (not simply the allocation mechanism). APRA also requires that the home supervisor's requirements (relating to the AMA) are sufficiently similar to those of APRA.

22. Basel II paragraphs 664, 666 and 674

Basel II includes specific risk management and governance criteria for use of the AMA. APRA's requirements are in some respects more precise and detailed including specific requirements relating to Board and senior management responsibilities and the operational risk management function.

23. Basel II paragraphs 667–668

Basel II sets quantitative standards regarding AMA soundness. APRA explicitly requires a number of elements regarding conservatism in modelling choices and assumptions including comprehensive and rigorous sensitivity analysis. These requirements are also applied to changes to the operational risk measurement system. APRA also requires ADIs to consider and document evolving industry practices in assessing its own practices.

24. Basel II paragraph 673

Basel provides guidance on operational risk losses that are related to credit risk. In addition to the Basel guidance, APRA requires fraud perpetrated by parties other than the borrower to be treated as operational risk (rather than credit-related) for the purpose of determining regulatory capital.

Counterparty credit risk

25. Basel II Annex 4 paragraphs 7–8

Basel sets the exposure at default estimate for counterparty credit risk for credit derivative protection at zero. APRA imposes a more stringent requirement as the exposure at default amount for such exposures is not set at zero.

Market risk

26. Basel 2.5 paragraph 709(ii)

Given that managing a correlation trading portfolio introduces additional complexity and risk, ADIs must seek APRA's approval in order to use the more favourable capital treatment.

Pillar 2

27. Basel II paragraphs 763–764

Basel includes interest rate risk in the banking book (IRRBB) as a Pillar 2 consideration. APRA requires a mandatory Pillar 1 capital charge for IRRBB for those ADIs using the IRB approach to credit risk and the AMA for operational risk.

Annex 11: List of approaches not allowed by APRA's regulatory framework

The following list provides an overview of approaches that APRA has not made available to its banks through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as "not applicable" for the assessment.

Credit risk: Internal Ratings-Based approach

- Internal models method for equity exposures
- PD/LGD approach for equity exposures
- Although not required under prudential standards, APRA's supervisory stance requires all specialised lending to be subject to the slotting approach

Operational risk

- Basic Indicator Approach

Counterparty credit risk

- Internal model method
- Standardised method
- Method 1 for default fund exposures