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BASEL III

ITS EFFECTS ON BANKS IN AUSTRALIA

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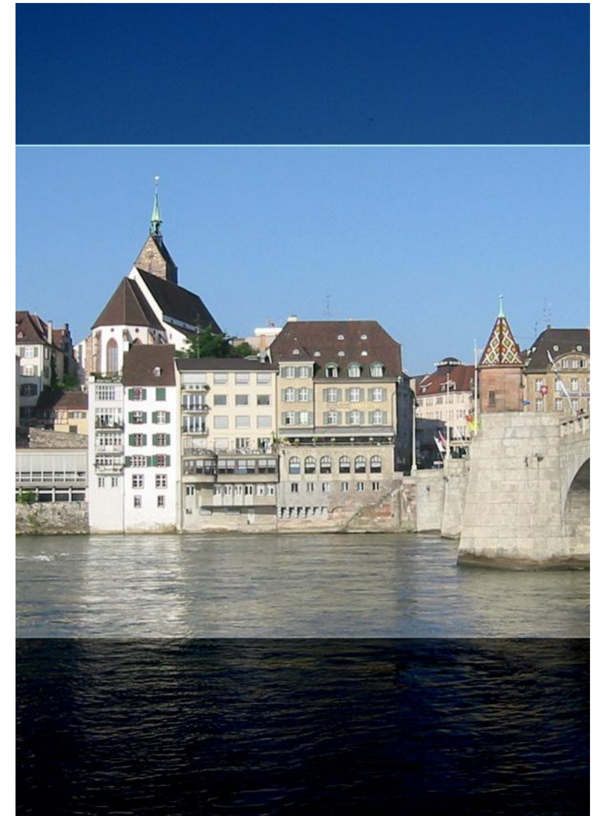
Basel III – Its effect on Banks in Australia

Four Questions

1. What does Basel III do?
2. What does Basel III not do?
3. How may our financial institutions react to Basel III?
4. Will Basel III produce a more resilient financial system?



1. What does Basel III do?

Strengthening Capital and Liquidity Requirements for Banks

Key BCBS documents

- **Core proposals**
  - Basel III: A global regulatory framework for more resilient banks and banking systems (16 December 2010 revised June 2011)
  - Basel III: International framework for liquidity risk measurement, standards and monitoring (16 December 2010)
- **Additional proposals**
  - Guidance for national authorities operating the countercyclical capital buffer (16 December 2010)
  - Basel Committee proposal to ensure the loss absorbency of regulatory capital at the point of non-viability (19 August 2010 updated 13 January 2011)
- **Key APRA documents**
  - Capital: Implementing Basel III Capital Reforms in Australia (and draft APS 001, 110, 111 and 222) (30 March 2012)
  - Liquidity: Implementing Basel III Liquidity Reforms in Australia (and draft APS 210) (16 November 2011)

Capital Requirements – Increase in Quantum and Quality

Increase in quantum by:

- increasing headline required percentages
- increasing the capital required for certain classes of asset
  - securitisation
  - trading book exposures
  - counterparty credit rate changes relevant to derivatives
- restricting dividends and discretionary distributions where capital levels fall below prescribed levels ("Capital Conservation Buffer")
- requiring additional common equity to be held where authorities judge that credit growth is resulting in an unacceptable build up of systemic risk ("Countercyclical Buffer")
- increasing items deducted from the calculation of required capital
- imposing a fall-back total leverage ratio ("Leverage Ratio")

Capital – Increase in Quantum from Basel II to Basel III

	Basel II	Basel III			
		Minimum	Conversion Buffer	Countercyclical Buffer	Total
Core Tier 1 / Common Equity	2%	4.5%	2.5%	0 - 2.5%	7.0% - 9.5%
Total Tier 1 (Common Equity + Additional Tier 1)	4%	6%			8.5%
Total Capital (Total Tier 1 + Tier 2)	8%	8%			10.5%
Deductions	Taken from total capital	Generally taken from Common Equity Tier 1			
Leverage Ratio	None	Tier 1 Capital / Expenses ≥ 3%			

** See next chart for effect of countercyclical buffer*

Capital – Operation of Capital Conservation Buffer and Countercyclical Buffer

Capital Conservation Buffer		Countercyclical Buffer of 2.5%	
Common Equity Tier 1 Capital ratio	Minimum Capital Conservation ratio (as a percentage of earnings)	Common Equity Capital Tier 1 ratio	Minimum Capital Conservation ratio (as a percentage of earnings)
4.5% - 5.125%	100%	4.5% - 7.5%	100%
>5.125% - 5.75%	80%	5.75% - 7.0%	80%
>5.75% - 6.375%	60%	7.0% - 8.25%	60%
>6.375% - 7.0%	40%	8.25% - 9.5%	40%
>7.0%	0%	> 9.5%	0%

What is restricted: dividends, share buy backs, discretionary payments on other Tier 1 instruments, discretionary bonus payments to staff

What are earnings: distributable profits calculated prior to the deduction of elements subject to restriction

Capital – Improvements in the Quality Of Capital

Quality of capital is improved by:

- requiring larger proportions of the required minimum to be satisfied by common equity
- requiring the Capital Conservation Buffer and Countercyclical Buffer to be met by common equity
- redefining
  - Common Equity
  - Additional Tier 1
  - Tier 2
- requiring additional loss absorbency features in capital instruments
  - Common Equity Capital Trigger Event (in liability accounted Additional Tier 1)
  - Non-viability Trigger Event

Liquidity – The Two Key Measures

a. Liquidity Coverage Ratio

$$\frac{\textbf{Stock of high quality liquid assets}}{\textbf{Total net cash outflows for next 30 days}} \geq 100\%$$

b. Net Stable Funding Ratio

$$\frac{\textbf{Available amount of stable funding}}{\textbf{Required amount of stable funding}} \geq 100\%$$

Liquidity Coverage Ratio

- High-quality liquid assets (“HQLA”)
  - liquid in markets during a time of stress
  - Level 1 assets (cash, 0% risk-weighted sovereign or quasi-sovereign bonds)
  - Level 2 assets (limited to 40% of pool and minimum 15% haircut applies to their value: 20% risk-weighted sovereign or quasi-sovereign bonds, corporate bonds rate AA- or better)
  - traded in large, deep active cash or repo markets
  - proven record as a reliable source of liquidity
  - not obligations of a financial institution
  - ideally central bank eligible
- In Australia:
  - Commonwealth Government and semi-government bonds
  - shortfall covered by committed secured liquidity facility with RBA

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 13-25

Liquidity Coverage Ratio

Measurement of Net Cash Outflows: Outflows – Minimum {inflows; 75% of outflows}

Cash Outflows:

Runoff rate (%)	Cash outflow category
	Retail cash outflows Retail deposits and small to medium enterprise ("SME") deposits where total deposits from each customer with the ADI do not exceed AUD2m. Includes call deposits and qualifying term deposits with residual maturity or notice period within 30 days:
5	• Stable deposits
10	• Less stable retail deposits
30	• Higher runoff less stable retail deposits
	Unsecured wholesale funding Non-financial corporate, sovereigns, central banks, public sector entities ("PSEs") and SME deposits of greater than AUD2m:
5	• Operational deposit balances covered by deposit insurance
25	• Operational deposit balances not covered by deposit insurance
75	• All other call deposits and qualifying term deposits with residual maturity or notice period within 30 days
100	• Deposits from other legal entities

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 21-23

Liquidity Coverage Ratio (cont…)

Cash Outflows: (cont…)

Runoff rate (%)	Cash outflow category
	Secured funding
0	• Secured funding transactions backed by HQLA1 assets, with any counterparty
15	• Secured funding transactions backed by HQLA2 assets, with any counterparty
100	• All other secured funding transactions
	Derivative transactions
100	• Derivative payables
100	• Collateral that would need to be posted as a result of a downgrade of 3-notches
100	• Collateral outflows due to market valuation changes on derivative transactions
20	• Valuation changes on posted collateral securing derivative transactions that is comprised of non-HQLA1 assets

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 21-23

Liquidity Coverage Ratio (cont…)

Cash Outflows: (cont…)

Runoff rate (%)	Cash outflow category
	Asset-backed commercial paper (ABCP), structured investment vehicles (SIVs), conduits, etc
100	• Liabilities from maturing ABCP, SIVs, conduits, etc
100	• Asset-backed securities including covered bonds
	Committed facilities
	• For the undrawn portion of committed credit and liquidity facilities:
5	○ to retail and SME
	○ to non-financial corporate, sovereigns and central banks, PSEs:
10	➢ credit facilities
100	➢ liquidity facilities
100	• Other legal entity customers
	Other contingent funding liabilities
As for committed facilities	• Revocable credit and liquidity facilities
Average of actual monthly outflows in a recent 12-month period	• Guarantees, letters of credit and other trade finance instruments
10 of short-term securities and 5 of long-term securities unless otherwise agreed with APRA	• Debt buybacks – domestic Australian debt securities
5	• Structured products, managed funds and other non-contractual obligations
To be set in consultation with APRA	• Issuers with an affiliated dealer or market maker
100	**Other items**

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 21-23

Liquidity Coverage Ratio

- **Retail vs Wholesale Deposits**
  - Funds placed with bank through intermediaries
- **Retail Deposits**
  - Stable vs Less Stable Deposit

Criteria	Score
Deposit balance is greater than the government guarantee threshold	2
Deposit is primarily internet accessed	2
Absence of an established customer relationship	1
Deposit is heavily rate-driven	1
The total score is then used to allocate the account or product deposit outflow as follows:	

Score	Outflow rate
0 – 2	10 per cent
3 or more	30 per cent

- Genuine fixed Term Deposits

Liquidity Coverage Ratio

Cash Inflows

- Certain inflows excluded (non-performing assets, reverse repos and securities borrowing, lines of credit from financial institutions)
- Retail and SME inflows – reduced by 50% on assumption the bank continues to lend
- Wholesale inflows – 100% from financial institution, reduced to 50% for non-financial wholesale counterparties on assumption the bank continues to lend
- Capped at 75% of outflows

Net Stable Funding Ratio – Measurement of Available Stable Funding

Funding with a maturity > 1 year and the proportion of other funding expected to stay with the bank

ASF factor (%)	Components of ASF category
100	• The total amount of capital, including both Tier 1 and Tier 2 as defined in Prudential Standard APS 111 Capital Adequacy: Measurement of Capital. • The total amount of any preferred stock not included in Tier 2 that has an effective remaining maturity of one year or greater taking into account any explicit or embedded options that would reduce the expected maturity to less than one year. • The total amount of secured and unsecured borrowings and liabilities (including term deposits) with effective remaining maturities of one year or greater excluding any instruments with explicit or embedded options that would reduce the expected maturity to less than one year. Such options include those exercisable at the investor's discretion within the one-year horizon.
90	• Stable non-maturity (demand) deposits and/or term deposits (as defined in the LCR in paragraph 32 of Attachment A) with residual maturities of less than one year provided by retail and SME customers.
80	• Less stable non-maturity (demand) deposits and/or term deposits (as defined in the LCR in paragraph 33 of Attachment A) with residual maturities of less than one year provided by retail and SME customers.
50	• Unsecured wholesale funding, non-maturity deposits and/or term deposits with a residual maturity of less than one year, provided by non-financial corporates, sovereigns, central banks, multilateral development banks and PSEs.
0	• All other liabilities and equity categories not included in the above categories.

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 27

Net Stable Funding Ratio – Measurement of Required Stable Funding

Value of assets held and funded by the ADI multiplied by a specific required stable funding factor assigned to each asset type

RSF factor (%)	Components of RSF category
0	• Cash immediately available to meet obligations, not currently encumbered as collateral and not held for planned use (as contingent collateral, salary payments, or for other reasons). • Unencumbered short-term unsecured instruments and transactions with outstanding maturities of less than one year. • Unencumbered securities with stated remaining maturities of less than one year with no embedded options that would increase the expected maturity to more than one year. • Unencumbered securities held where the ADI has an offsetting reverse repurchase transaction when the security on each transaction has the same unique identifier. • Unencumbered loans to financial institutions with effective remaining maturities of less than one year that are not renewable and for which the lender has an irrevocable right to call.
5	• Unencumbered marketable securities with residual maturities of one year or greater representing claims on or claims guaranteed by sovereigns, central banks, BIS, IMF, EC, non-central government PSEs or multilateral development banks that are assigned a zero per cent risk-weight under the standardised approach to credit risk in APS 112, provided that active repo or sale-markets exist for these securities.
10	• Unencumbered securities held, for the sole purpose of compliance with the LCR, under the ADI's committed secured liquidity facility with the RBA. This excludes all self-securitisations, to which in accordance with this Table 2, a 65, 85 or 100 per cent RSF factor must apply, depending on the RSF of the underlying loans.

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 28-30

Net Stable Funding Ratio – Measurement of Required Stable Funding (cont…)

Value of assets held and funded by the ADI multiplied by a specific required stable funding factor assigned to each asset type (cont…)

RSF factor (%)	Components of RSF category
20	• Unencumbered corporate bonds or covered bonds rated AA- or higher with residual maturities of one year or greater satisfying all of the conditions for HQLA2 in the LCR. • Unencumbered marketable securities with residual maturities of one year or greater representing claims on or claims guaranteed by sovereigns, central banks, non-central government PSEs that are assigned a 20 per cent risk-weight under the standardised approach to credit risk in APS 112, provided that they meet all of the conditions for HQLA2 in the LCR.
50	• Unencumbered gold. • Unencumbered equity securities, not issued by financial institutions or their affiliates, listed on a recognised exchange and included in a large cap market index. • Unencumbered corporate bonds and covered bonds that satisfy all of the following conditions: a. central bank eligibility for intraday liquidity needs and overnight liquidity shortages in relevant jurisdictions; b. not issued by financial institutions or their affiliates (except in the case of covered bonds); c. not issued by the ADI itself or its affiliates; d. low credit risk: assets have a credit assessment by a recognised ECAI of A+ to A-, or do not have a credit assessment by a recognised ECAI and are internally rated as having a PD corresponding to a credit assessment of A+ to A-; and e. traded in large, deep and active markets characterised by a low level of concentration. • Unencumbered loans to non-financial corporate clients, sovereigns, central banks and PSEs having a remaining maturity of less than one year.

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 28-30

Net Stable Funding Ratio – Measurement of Required Stable Funding (cont…)

Value of assets held and funded by the ADI multiplied by a specific required stable funding factor assigned to each asset type (cont…)

RSF factor (%)	Components of RSF category
65	• Unencumbered residual mortgages of any maturity that would qualify for the 35 per cent or lower risk-weight. • Other unencumbered loans, excluding loans to financial institutions, with a remaining maturity of one year or greater, that would qualify for the 35 per cent or lower risk-weight.
85	• Unencumbered loans to retail customers (i.e. natural persons) and SME customers having a remaining maturity of less than one year (other than those that qualify for the 65 per cent RSF above).
100	• All other assets not included in the above categories.

Source: APRA, Draft Prudential Standard APS 210: Liquidity, Nov 2011, 28-30

Systemically Important Financial Institutions

Global-SIFIs

- Identified by size, interconnectedness, lack of available substitutes, global activities and complexity
- Reduce the probability of failure by requiring additional 1% - 3.5% common equity to risk weighted assets
- Reduce the impact of failure by improving global recovery and resolution frameworks
- No Australian Bank on the list

Domestic-SIFIs

- To be identified by national authorities
- Higher loss absorbency requirements to be imposed commensurate with systemic importance and fully met from common equity Tier 1

Source: BCBS, 'Global systemically important banks: assessment methodology and the additional loss absorbency requirement' (BIS, Rules Text, Nov 2011); BCBS, 'A framework for dealing with domestically important banks' (BIS, Consultative Document, Jun 2012)

2. What Does Basel III Not Do?

- Basel III is not self executing
  - it requires implementation by national jurisdiction
- Basel III contains extensive principles for supervision, but not comprehensive rules
  - the definition of banks and shadow banks
- Doesn’t create financial markets (eg capital markets) to provide liquid assets or longer term funding
- Doesn’t mandate structural separation of financial market activity
- Doesn’t consider other objectives of financial regulation (eg competition)
- Doesn’t reform national insolvency regimes

3. How May Financial Institutions React To Basel III?

Timetable of Implementation

Phase-in arrangements (shading indicates transition periods – all dates are as of 1 January)									
	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins							Introduce minimum standard	

Shadings show APRA implementation
Red – To be implemented 1 January 2013
Blue – To be implemented 1 January 2016
Yellow – To be implemented as per BCBS timetable

Source: BCBS, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (BIS, Dec 2010)

Reaction To Capital Requirements

So will this lead to capital raisings?

	ANZ (iii)			CBA (iv)			NAB (v)			WBC		
	6mths Mar-12	6mths Sep-11	6mths Mar-11	6mths Dec-11	6mths Jun-11	6mths Dec-10	6mths Mar-12	6mths Sep-11	6mths Mar-11	6mths Mar-12	6mths Sep-11	6mths Mar-11
Capital ratios												
Common equity	8.9%	8.5%	8.5%	7.7%	7.7%	7.4%	8.0%	7.6%	7.1%	8.0%	8.1%	8.0%
Tier 1	11.3%	10.9%	10.5%	9.9%	10.0%	9.7%	10.2%	9.7%	9.2%	9.8%	9.7%	9.5%
Tier 2 (net of deductions)	1.3%	1.2%	1.6%	1.2%	1.7%	1.8%	1.3%	1.6%	2.1%	1.0%	1.3%	1.5%
Total	12.6%	12.1%	12.1%	11.1%	11.7%	11.5%	11.5%	11.3%	11.3%	10.8%	11.0%	11.0%

Effect on capital intensive asset classes

- repricing?
- exit?

Source: PwC, 'Major Banks Analysis: Delivering solid, not spectacular growth' (May 2012)

Reaction To Liquidity Rules

A chronic shortage of Liquid Assets as currently acceptable to APRA …

- Commonwealth Government Securities on issue as a proportion of GDP: 15%
- State Government Securities on issue as a proportion of GDP: 12%
- Estimated need for Liquid Assets on a proportion of GDP: 40%
- Excessive demand, especially foreign demand: 60% of Commonwealth Government Securities, State Government Securities on issue are held by foreigners

Source: Guy Debelle, 'The Committed Liquidity Facility' (Speech delivered at the APRA Basel III Implementation Workshop 2011, Sydney, 23 Nov 2011); Australian Bureau of Statistics

Reaction To Liquidity Coverage Ratio

Reliance on the RBA Committed Liquidity Facility (CLF)?

- APRA's every reasonable effort must be made to manage liquidity risk

Immediate Actions

- Purchase High Quality Liquid Assets
- Increasing Maturity Profile
  - 30 day call deposits
  - true fixed deposits
- Reducing cash outflows
  - increasing retail deposits
    - marketing
    - structuring – wholesale intermediaries and retail money
  - limiting reliance on flighty money
    - internet delivery channels
    - short term wholesale funding
  - maximising deposits covered by the Financial Claims Scheme
  - re-pricing or limiting the supply of liquidity facilities

Reaction To Liquidity Coverage Ratio

Immediate Actions (cont…)

- The RBA Committed Liquidity Facility
  - Eligible Collateral
  - Government and Semi Government Bonds
  - A$ Domestic issues by foreign governments and supra-nationals
  - Covered Bonds
  - Asset Banked Securities
  - Self securitisation of mortgages
  - the fee of 15bps

Longer Term

- How to create what is accepted by regulators as a liquid, domestic corporate bond market to qualify as Level 2 Assets?
  - wholesale or retail?
  - need for Government initiative

Responses To Net Stable Funding Ratio

- Lengthening Funding Tenor beyond 12 months
  - techniques similar to those for improving position under Liquidity Coverage Ratio
- Shortening Lending Tenor?
- Holding of assets with a maturity > year but with concessional treatment
  - liquid highly rated corporate bonds
  - gold
  - 35% risk weighted residential mortgages
- Prepayment rights and penalties

Broader Implications

Business Developments

- Jurisdictional Arbitrage
- Transference of Business
  - to capital markets / end investors
  - to other prudentially regulated entities
  - to shadow banks

Regulatory Responses

- Internationalisation or a re-assertion of territoriality?
- The extension of prudential regulation or ring-fencing and structural separation?

4. Will Basel III Succeed?

Risks to the success of Basel III

- Failure to implement consistently, internationally
- Failure to anticipate novel, toxic asset classes
- Being outflanked by the development of shadow banking
- Failure to achieve real risk transfer through financial markets:
  - requirements for liquid, domestic capital markets
  - the regulation and membership of central counterparties

4. Will Basel III Succeed?

A cautionary tale …