ABA submission on the Basel Committee's Strengthening the resilience of the banking sector

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Executive summary

Experiences from the recent global financial crisis (GFC) underscore the need for regulatory change. However, the ABA is concerned that the regulatory changes proposed in the Committee's Consultative Documents are potentially overly severe and may present an impediment to longer term growth. For liquidity, the proposed changes transfer too much of the burden of liquidity risk "insurance" to the banking system. Similarly for counterparty risk, there is the potential for banks to be required to hold excessive amounts of capital against over-the-counter (OTC) derivative exposures with very limited ability to transact with central counterparties (CCPs) in the short to medium term. While for capital it is more difficult to ascertain the overall impact of the changes until the Committee releases "calibrated standards", we anticipate that the overall impact could be very significant.

The ABA is concerned that "over-calibration" of the capital changes, when combined with the changes to liquidity, will give rise to a significant slowdown in the availability of credit, and an increase in its cost, thereby presenting an impediment to economic recovery and longer-term growth. The main channel through which the impact will be transmitted is interest rates. More stringent capital requirements, coupled with the requirement to hold lower yielding liquid assets, will inevitably put pressure on banks to recover the additional costs incurred through increases in the cost of lending. This outcome, coupled with the changes to bank lending resulting from the revised liquidity requirements, and the potential flow-on effects from lower bank share prices, will ultimately give rise to contractions in economic growth.

Estimating the potential impact is complicated by the need to make assumptions about the Committee's possible calibration, as well as by the linkages that exist between the various components of the framework. In terms of the latter, the linkages between components, such as between the minimum capital requirement and the proposed capital buffers, or between the definition of capital and forward-looking provisioning, are particularly complex. Compounding this complexity is the Committee's objective to align accounting and regulatory approaches to provisioning.

The ABA is also concerned that the capital changes proposed in the Resilience Document will give rise to a much more prescriptive level of supervision, with the proposal to introduce a capital conservation range effectively transferring a significant element of responsibility for capital management from banks' boards to regulators. Further, the proposal to adjust capital buffers in response to both excessive credit growth and pro-cyclicality in the minimum capital requirement, may lead to an overall *increase in minimum required capital* over and above the calibrated minimum that the Committee will set. This change, coupled with the proposal to require larger banks to hold additional capital and for banks to build and conserve capital in normal times, suggests that banks will be required to hold *significantly* more Tier 1 capital than they are currently holding. We also question whether capital buffers will be able to work as intended, as the willingness of the

market and supervisors to allow capital buffers to be wound back under stressed conditions would be limited.

Policy development timeframes and implementation and transition considerations

In view of the complexity of the revised framework, and the potential severity of the proposed changes, further analysis, discussion and debate with industry are needed to aid in ensuring that the Committee's target level of resilience strikes the right balance between the benefits and costs of a more resilient system. There is also a clear need for further impact assessment once the components of the framework, and their calibration, are more firm.

Depending on the significance of the changes, implementation over a longer period will assist in reducing the severity of adverse macroeconomic impacts. There may be a need for the framework to be phased in gradually, consistent with global economic recovery. A phased approach provides the benefit of allowing reforms to be implemented on schedule while allowing flexibility for policy makers to finely tune the requirements over time in order to minimise the risks to global economic recovery.

As recognised by the Committee, there is also a need for capital instruments that no longer meet the criteria set out in the capital framework, or that are in excess of any capital limits imposed, to be *"grandfathered"*. The ABA is strongly of the view that capital instruments should be able to continue to be issued (and still be eligible for grandfathering) until the time that the framework is implemented. This will minimise the disruption to the capital market that will occur so long as there is uncertainty in the framework. Early clarification of grandfathering arrangements is therefore requested to enable banks to continue to manage their capital raising activities.

Irrespective of the approach to transition adopted, it is essential that the framework be implemented on a globally consistent basis to ensure comparability and a level playing field across jurisdictions. This includes the period of grandfathering for capital instruments. Adoption by jurisdictions at very different times and/or phasing in of the framework over different periods would significantly undermine the goal of an internationally harmonised framework that supports comparability across jurisdictions.

International consistency

The ABA acknowledges, and generally agrees with, the Committee's objective of developing an internationally harmonised regulatory framework. However, we believe that this is best achieved by developing a regulatory framework that is based on clearly articulated objectives and principles that allow national supervisors to implement the framework in a manner that meets these objectives, while responding to constraints or impediments posed by the local environment.

For liquidity, meeting the Committee's objective of a harmonised framework is difficult in that liquidity is largely a "local construct" where the structure and constraints of local financial markets have a significant bearing on local balance sheet structures. For capital, it should be possible to develop a regulatory framework that is more consistent across jurisdictions given that capital is a

largely "global construct", notwithstanding that it is affected by local taxation, legal and accounting requirements.

In particular, the definition of the capital base and its associated deductions (such as the treatment of undeclared dividends) should be able to be implemented consistently with minimal national discretion. Similarly, for measures of risk-weighted assets, it is important that the regulatory framework adopt consistent methods for measuring risk (this includes the consistent capture and disclosure of risks such as interest rate risk in the banking book being in Pillar 1 or Pillar 2). Consistent definitions of capital and consistent measurement methods for risk-weighted assets will facilitate useful comparisons by markets of the relative capital strengths of banks across jurisdictions.

Implementing the leverage ratio and capital buffers as part of Pillar 2

The regulatory changes are focused heavily on additional prescriptive regulation under the realm of Pillar 1 minimum capital requirements. While we agree that additional regulation is warranted and strongly support the need for a "base level" of comparative information on relative bank capital strength as part of Pillar 1, we emphasise the importance of improved supervisory analysis and challenge as part of national supervisors' Pillar 2 regimes. Undue focus on Pillar 1 may have the unintended consequences of less rigorous challenge by supervisors and the application of a "one size fits all" approach that is not tailored to the riskiest or most vulnerable components of a bank's activities, and which penalises low risk banks.

Consistent with the Basel II framework, a robust framework developed as part of Pillar 2 should encourage national supervisors to tailor review processes to suit each bank's risk profile and encourage banks themselves to develop internal capital assessment processes (including the setting of capital targets) that align with their risk appetites. We emphasise that implementation of supervisory tools (such as the leverage ratio and capital buffers) as part of Pillar 2 should not reduce the role that these tools play in the supervisory framework nor the scrutiny or importance placed by national supervisors on the applications of these tools. In Australia, this has been clearly demonstrated by the Australian Prudential Regulation Authority's (APRA's) application of the Pillar 2 supervisory review process and, as part of that process, the setting of bank-specific prudential capital ratios (PCRs) that are tailored to individual bank risk profiles[1].

Implementation of the proposed leverage ratio through national supervisors' Pillar 2 frameworks will allow effective use as a challenge of Pillar 1 outcomes. It should not, however, replace risk-based capital assessment as the cornerstone of the supervisory framework. We note that the Committee has not, to date, set a fixed outcome or cap on the leverage ratio. This is a sensible approach and recognises that the bluntness of the tool is such that its value must be determined by national supervisors on a bank-by-bank basis. To do otherwise may distort market and supervisors' assessments of the relative riskiness of banks within and across jurisdictions. The leverage ratio works best as a monitoring tool for supervisors in their Pillar 2 review processes.

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[1] The main body of this submission provides further details of APRA's application of Pillar 2 and the PCR mechanism.

The Committee's proposal to introduce a capital buffer as a means of dampening pro-cyclicality and to encourage capital conservation should also be implemented through Pillar 2. Pillar 1 implementation would suggest a "one-size-fits-all' approach to the size of the capital buffer. This would clearly be inappropriate in that the capital buffers should reflect the potential volatility in a bank's minimum capital requirement which in turn, will depend on the bank's own risk profile and on the potential procyclicality of the bank's portfolio. The ABA is also of the view that a mechanistic approach to the determination of capital buffers transfers a significant element of responsibility for capital management from bank boards to regulators. A Pillar 2 approach will allow alignment with banks' own capital management processes and will avoid application of a mechanistic approach to capital management that is not reflective of the risks that bank capital is intended to support.

The definition of capital

The ABA supports the Committee's objectives of simplifying the regulatory capital base and improving its quality, consistency and transparency to absorb losses on both a going concern and gone concern basis. Consistent with the comments made above, the ABA is of the view that an internationally harmonised approach to the definition of capital, including deductions, is a sensible goal and will facilitate more rigorous analysis by the market of banks' relative capital positions.

While the ABA also supports the Committee's three-tiered approach to capital, we believe that greater clarity is required in respect of the relative roles of the three tiers, particularly Tier 1 Additional Going Concern capital. Further, we are of the view that more work is needed to align the criteria for Tier 1 Additional Going Concern capital with its role in banks' capital structures. In particular, the inclusion of a requirement for principal loss absorption for Tier 1 Additional Going Concern capital does not accord with its role as an absorber of loss only after Common Equity has first absorbed a material portion of losses. To the extent that inclusion of a principal loss absorption requirement is only relevant in those jurisdictions where national insolvency law includes a "liabilities-greater-than-assets" balance sheet test, this should be clarified in the revised framework.

The ABA is also of the view that the Committee's proposed approach to capital adjustments for certain assets, such as capitalised software expenses, deferred tax assets and investments in non-consolidated insurance entities should be reviewed. All of these assets will have value on a going concern basis. For capitalised software expenses and deferred tax assets, on a gone concern basis their values will be zero. The value of net tangible assets for investments in non-consolidated insurance entities will under most circumstances be something greater than zero on both a going and gone concern basis. In the interest of simplicity, we recommend that the Committee adopt a 50/50 Tier 1/Tier 2 approach for these assets. To deduct the value of those assets from Common Equity undermines the conceptual framework for the capital structure that the Committee has proposed.

Counterparty credit risk

The Resilience Document sets out a number of proposed changes in relation to the treatment of risk relating to counterparty transactions. It is not clear whether the Committee has determined its view on an appropriate "regulatory architecture" for financial system counterparties and associated transactions. As

a consequence, the proposed changes appear piecemeal and somewhat disjointed. Clear articulation of a target design for the counterparty risk framework is essential if the industry is to understand and work to the objectives that the Committee is aiming to achieve. For example, there remains considerable uncertainty as to the process for recognition of a CCP as well as those derivatives that should be cleared through these counterparties.

Main recommendations

Against the backdrop of the above considerations, the ABA makes the following main recommendations[2] each of which is considered in further detail in the submission:

<u>Main Recommendation 1:</u> The Committee's timetable should allow for further impact assessment and industry consultation. Implementation of the final changes should be phased and globally consistent and capital instruments grandfathered.

The ABA is concerned that the completeness and integrity of the policy setting process is being compromised by the aggressive timetable that has been set by the G20 Leaders. To ensure that the final changes will support the industry over the longer term, the ABA recommends that there be further industry consultation, debate and challenge globally once the Committee's impact analysis is complete. The process that the Committee is working through should also take account of the complex inter-linkages between the various elements of the proposed revised capital adequacy framework. To do this, the ABA recommends that the Committee adopts a phased approach to policy development that determines first some of the core components of the framework, such as the definition of capital and the prudential treatment of provisions and expected loss, before determining other components of the framework that depend on some of the aforementioned components (such as minimum capital requirements and measures to dampen pro-cyclicality).

The ABA recommends a globally consistent approach to implementation. It is essential that all jurisdictions implement the changes at the same time to minimise market confusion and misinterpretation, facilitate comparability and market discipline and ensure a level playing field across banks. Depending on the shape and form of the final framework, the approach may need to be phased to avoid adverse macroeconomic outcomes. Grandfathering periods should be similarly consistent across jurisdictions and take effect from the time that the framework is implemented. Further, the ABA recommends an approach that specifies the amounts of grandfathered hybrid capital eligible for inclusion as a percentage of Tier 1 capital with the allowable percentage gradually reduced over time.

<u>Main Recommendation 2:</u> The regulatory framework for capital should be based on clearly articulated objectives and principles so as to achieve a consistent level of resilience. Discretion exercised by national supervisors on the definition of capital can and should be kept to a minimum. National supervisors' implementations of the framework should be transparent and readily justified.

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[2] These recommendations are combined with other recommendations in the body of the submission.

The ABA recommends that the regulatory framework be based on clearly articulated objectives and principles that allow national supervisors to implement the framework in a manner that meets the objectives of the framework while responding to the constraints or impediments posed by the local environment, including local market and economic conditions, as well as local taxation, accounting and legislative requirements. To maintain consistent standards across supervisors, we recommend that the framework require national supervisors to explain, by way of local prudential policies, the linkages between the principles laid out by the Committee and national supervisors' local implementations of those principles in the context of jurisdiction-specific factors.

Main Recommendation 3: The revised regulatory framework should make more effective use of Pillar 2. The simple leverage ratio and capital buffers should form part of the Pillar 2 framework. Irrespective, capital buffers should be identified separately to minimum capital requirements.

The ABA emphasises the importance of improved supervisory analysis and challenge as part of national supervisors' Pillar 2 regimes and recommends that the leverage ratio and capital buffers form part of their Pillar 2 frameworks. In line with the Basel II framework, Pillar 1 provides for a minimum level of required capital in banks that facilitates comparison across jurisdictions. Pillar 2 allows supervisors to adjust regulatory capital, as determined by Pillar 1, to ensure its appropriateness for the risk profiles of individual banks.

Consistent with this thinking, the ABA recommends that the leverage ratio be implemented as a Pillar 2 measure. While we acknowledge the value of a simple measure of leverage that facilitates comparisons across banks that is not clouded by complex risk models, the bluntness of the tool and the significant variation in accounting frameworks across jurisdictions is such that its value must be determined by national supervisors on a bank-by-bank basis and should not replace risk-based capital as the foundation stone of the supervisory framework.

Similarly the ABA recommends that capital buffers introduced to dampen pro-cyclicality should form part of the Pillar 2 framework. It is important that these buffers are specifically identified as separate from the minimum capital requirement and not subsumed within the overall pool of core Tier 1 capital. Moreover, all three counter-cyclical buffers proposed by the Committee, namely those relating to cyclicality of the minimum capital requirement, capital conservation and excessive credit growth, should be considered collectively in determining an appropriate overall capital buffer in excess of the minimum capital requirement.

To maintain a consistent minimum level of soundness across jurisdictions, Pillar 2 implementation should be accompanied by adequate supervisory disclosure and be subject to the peer review processes that have been proposed by the Financial Stability Board.

Main Recommendation 4: The role of Tier 1 Additional Going Concern capital should be clarified, including that a principal loss absorption mechanism only apply in those jurisdictions where it is required by national insolvency law.

The ABA is of the view that Tier 1 Additional Going Concern capital should only absorb losses once Common Equity has first absorbed a material portion of

losses. To require otherwise would not be economically viable for Tier 1 Additional Going Concern capital holders. The criteria proposed in the Resilience Document are not consistent with this philosophy; hence the ABA seeks clarification from the Committee as to the relative roles of Common Equity and Tier 1 Additional Going Concern capital in absorbing loss. The Committee's proposal to include, as a criterion for Tier 1 Additional Going Concern capital, a requirement for principal loss absorption is potentially problematic, depending on where the trigger point for loss absorption is set. In our view, inclusion of a mechanism to achieve principal loss absorption may only be relevant in those jurisdictions where national insolvency law includes a "liabilities-greater-than-assets" balance sheet test. We recommend that the principle rather than the mechanism be required in the framework. To the extent that this criterion remains, we recommend that conversion into common shares, rather than a write-down mechanism, be adopted and that conversion be to a variable rather than fixed number of common shares, subject to a maximum dilution floor, to avoid exposing the capital instrument holder to share price volatility (and loss of principal) ahead of the conversion.

<u>Main Recommendation 5:</u> The proposed approach to deductions should be revised to one that: recognises the value of some assets on a (stressed) going concern basis; allows both going concern and gone concern capital to share in the risk of loss; and for all deductions allows for consistency and relative simplicity.

The ABA supports the Committee's approach to harmonising capital deductions. We highlight that the changed approach will impact some banking groups more than others and recommend that the outcomes of the Committee's impact assessment be considered in the context of how the changes will impact economic activity in the short to medium term.

The deduction approach proposed in the Resilience Document does not recognise that some assets, specifically capitalised software expenses, deferred tax assets and investments in non-consolidated insurance entities, which the Committee proposes be deducted from Common Equity, will continue to have value on a going concern basis even under periods of stress (although we recognise that these values may fluctuate). Values for capitalised software expenses and deferred tax assets will be zero on a gone concern basis. Investments in non-consolidated insurance entities will, under most circumstances, have value on a gone concern basis. In the interest of simplicity, we recommend that the Committee adopt 50/50 Tier 1/Tier 2 approach for capitalised software expenses and deferred tax assets and retain the current 50/50 Tier 1/Tier 2 approach for investments in non-consolidated insurance entities. The proposal to deduct the value of those assets from Common Equity undermines the conceptual framework for the capital structure that the Committee has proposed.

We also note that the proposals do not address the treatment of dividends in the regulatory capital framework. To facilitate simplicity and transparency, we recommend that the Committee develop an internationally consistent approach to the treatment of dividends[3].

<u>Main Recommendation 6:</u> For counterparty credit risk, the Committee should clarify its "target architecture" for financial counterparties and CCR, including the policy intent of the CVA capital charge. The CVA framework should allow for more sophisticated approaches to modelling CVA that better capture the complexity of these risks. The overall level of the CVA capital requirement should be recalibrated and a broader set of hedges allowed for the purpose of measuring CVA risk.

The ABA is of the view that the Resilience Document specifies the desired outcomes of the proposed changes (such as the desire to raise capital requirements) but does not provide sufficient detail in relation to the target regulatory architecture of financial counterparties and associated transactions. This includes the Committee's policy intent in relation to the components of CCR as well as the Committee's framework for CCPs, particularly, the process for accrediting and supervising CCPs and identification of those over-the-counter (OTC) derivatives transactions that can be cleared by CCPs. The ABA recommends that the Committee clarify its policy intent and target architecture in relation to the CCR and CCP frameworks. The ABA also recommends clarification from the Committee as to its definition of CVA risk. In particular, it is unclear whether the definition is intended to align with the CVA accounting provision or whether it is intended to capture more forward looking elements of CVA.

The ABA recommends that the framework for characterising CVA risk allow for use of more sophisticated approaches to CVA measurement. The ABA is of the view that the proposed bond equivalent approach is not appropriate in all instances. More sophisticated approaches are available that will better capture CVA risk. Use of more sophisticated approaches would not only improve the risk-sensitivity of regulatory capital requirements but would also allow banks to align techniques for measuring regulatory capital with those used for management of counterparty risk.

The ABA is concerned that the combined impact of the various components of the calculation would increase capital requirements to a level not commensurate with the risk, giving rise to excessive costs to OTC derivative customers. The market implications for such an outcome would be wide ranging and include a transfer of risk toward the non-regulated sector. It is unclear to the ABA if such an impact is in accordance with the overall target regime of the Committee. In the case of measuring the maturity of the bond equivalent, the ABA recommends the use of a weighted average maturity approach which will closer align to the CVA risk profile. For institutions applying standardised market risk rules to the bond equivalents, the ABA is of the view that using the present value of the bond

[3] Work undertaken by Australian banks to understand differences in regulatory capital frameworks across jurisdictions suggests that deductions for expected but not yet declared dividends is an important driver of differences in capital outcomes and a significant source of confusion for the market.

equivalents produces capital requirements that more appropriately reflect the CVA risks inherent in the portfolio.

The ABA recommends that the capital calculation for CVA risk allow recognition of a broader set of hedges than CDS, such as index CDS, consistent with how banks manage CVA risk. Such an approach would allow banks to use products that can be flexible enough to provide economically effective hedges against CVA risk.

1. Introduction

This submission sets out the Australian Bankers' Association's (ABA's) response to the Basel Committee on Banking Supervision's ("the Committee's") Consultative Document *Strengthening the resilience of the banking sector* ("Resilience Document")*,* issued for comment on 17 December 2009[4].

The recent global financial crisis (GFC) highlighted many weaknesses in the way in which banks around the world measure and manage risk, as well as in the international framework for regulating and supervising banks and other financial institutions. It also highlighted the vulnerabilities of the banking system to excessive leverage and the importance of having in place a high quality capital base and capital buffer to absorb losses. Underscoring many of the lessons from the GFC is the importance of transparency to facilitate market understanding and comparability across banks operating in different jurisdictions. The regulatory framework plays an integral role in this regard.

While there is unquestionably a need for regulatory change in the aftermath of the GFC, there is a question as to the form of that change and whether the extent of change agreed may have significant adverse outcomes if implemented with insufficient understanding of its full consequences including second round impacts. There are many opportunities where a stronger prudential framework could be achieved by *improved supervision* rather than *additional regulation*. It is not clear that more regulation will necessarily reduce the possibility of another GFC; instead an appropriate balance must be struck between regulation and supervision or implementation of regulatory frameworks.

The ABA supports the Committee's objective of implementing an internationally harmonised capital and liquidity framework that is simple to understand and compare across jurisdictions. However, the ABA is concerned that the severity of the changes proposed in the Committee's Consultative Documents will ultimately present an impediment to economic recovery and to longer term economic growth. We note that the Committee is currently working through a process to assess the impact of the Consultative Documents and we encourage rigorous debate, analysis and industry consultation to ensure the ongoing suitability of the regulatory framework for meeting the Committee's stated objectives of resilience, innovation, efficiency and sustainable growth.

The ABA is also concerned that implementation of many of the changes proposed are based on additional prescriptive regulation under the realm of Pillar 1. In Australia, Pillar 2 has played, and should continue to play, an important role in the regulatory framework. We are strongly of the view that many of the Committee's objectives are better met by enhanced Pillar 2 implementation coupled with a stronger disclosure regime. Undue focus on Pillar 1 may have the unintended consequences of less rigorous challenge by supervisors and the application of a "one size fits all" approach that is not tailored to the riskiest or most vulnerable components of a bank's activities and which penalises lower risk

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[4] The ABA's response to the Consultative Document *International framework for liquidity risk measurement, standards and monitoring* ("Liquidity Document") has been provided to the Committee in a separate submission. The Resilience Document and the Liquidity Document are referred to collectively in this submission as the"Consultative Documents".

banks. Implementation through Pillar 2 encourages national supervisors to tailor review and challenge processes to suit each bank's risk profile.

This submission sets out the ABA's key concerns in relation to the proposed regulatory changes in the Resilience Document. **Section 2** discusses the policy development time frame and the importance of having globally consistent implementation and transition. **Section 3** discusses the importance of a harmonised regulatory framework for capital. **Section 4** considers the role played by Pillar 2 and the reasons for including some of the proposed supervisory measures in the Pillar 2 framework: **Section 4.1** provides some comments on the Committee's plans to introduce a leverage ratio; and **Section 4.2** sets out the ABA's response to the Committee's proposals for dampening pro-cyclicality. **Section 5** considers the changes in relation to the definition of capital and rules on capital deductions. **Section 6** remarks on the Committee's deliberations in relation to counterparty credit risk and systemically-important institutions. **Section 7** remarks briefly on disclosure and **Section 8** considers the macroeconomic implications of the changes.

2. Policy development timeframes, implementation and transition

2.1 The importance of industry consultation and a measured timetable

There is unprecedented activity currently under way in relation to the Consultative Documents, both by regulators and industry. This activity includes not only ongoing policy development and interpretation, but also "top-down" consideration of regulatory targets and, importantly, the implications of the regulatory changes proposed. The Committee has indicated that it expects to release "calibrated" requirements for capital and other standards by the end of 2010. The requirements will be *"phased in as financial conditions improve and the economic recovery is assured, with an aim of implementation by end-2012"*.

The ABA is concerned that the political nature of the policy-setting response and the aggressive timetable set by the G20 Leaders may be impairing the policy development process and the possibility of achieving an effective and sustainable regulatory framework. Without question, implementation of the regulatory framework will have tremendous implications for the global economy, as well as for the operations of individual banks. It is prudent to assess the impact of all of the policies under development as an inter-related suite of policies, as indeed the Committee is doing through the Quantitative Impact Study (QIS). However, it is also important to ensure that the benefits of each proposal outweigh its costs and that the practical application of the framework is "tested and challenged" through industry consultation and debate. This is essential if the framework is to meet the Committee's objectives of achieving an appropriate balance between increased resilience, innovation, efficiency and sustainable growth and ensuring that all countries "opt-in" to the regulatory framework adopted. The current timetable proposed may not allow enough time for this analysis and consultation to take place.

The timetable may also not allow sufficient time for the Committee to consider the practical application of the regulatory changes. Consultation with industry can be a useful mechanism in this regard. Indeed, many of the changes proposed, particularly those relating to capital instrument criteria, the leverage ratio calculation and pro-cyclicality, are extremely complex. It is difficult to

develop detailed policy relating to these proposals when the objectives and targets of the regulatory changes are still undetermined. Similarly, it is difficult for industry to provide detailed comment on the proposals when the objectives of the Committee are not stated in the Consultative Documents.

To ensure that the final changes will support the industry over the longer term, the ABA recommends that the process that the Committee is working through take account of the complex inter-relationships between the various elements of the proposed revised capital adequacy framework. To do this, the ABA recommends that the Committee adopt a phased approach to policy development that determines first some of the core components of the framework, such as the definition of capital and the prudential treatment of provisions and expected loss, before determining other components of the framework that depend on some of the aforementioned components (such as minimum capital requirements and measures to dampen pro-cyclicality).

2.2 Implementing the final framework

Once finalised, the regulatory framework will require time to be absorbed by the economy and by regulated banks, both to facilitate appropriate implementation and to allow for changes in activity. Against the backdrop of the economic implications set out earlier in this submission, and depending on where the final framework settles in terms of minimum capital requirements, the definition of capital, liquid assets, term funding requirements and a range of other items, the ABA recommends a phased approach to implementation of the regulatory standards. Moreover, the timing and transition of the regulatory framework should be consistent around the world. Other requirements in the proposals, such as the implementation of monitoring tools, as well as additional standards proposed by national supervisors, could be subject to a shorter transition period.

A phased approach to implementation will also provide time for financial markets to absorb the regulatory changes. This is particularly important given the financial market responses observed to date. Financial markets will behave more rationally if given time to adjust. Sudden shifts in the demand for certain types of funding, as well as in the supply of particular capital instruments, can create unwarranted distortions in prices in response to such anticipated or actual changes.

For capital instruments on issue, the ABA acknowledges recognition by the Committee that appropriate grandfathering should be established, given the significance of the changes proposed and the importance of minimising disruption to currently outstanding capital instruments. Having said that, it is not clear that the framework will require all jurisdictions to adopt grandfathering or that grandfathering periods will be consistent. Uniform implementation of grandfathering requirements across jurisdictions is essential so as not to create regulatory arbitrage between countries. This is particularly important for "hybrid capital" given the global nature of capital and the sensitivity of particular capital structures to regulatory requirements.

Current policy uncertainty in relation to capital recognition is preventing banks from undertaking new issuances until such time as the capital criteria are firm, giving rise to the possibility that hybrid capital investors will move to other markets and the hybrid market may contract as a result. In view of this, hybrid

capital instruments should be grandfathered in *all* jurisdictions from the date that the internationally harmonised capital framework is finalised by the Committee rather than from December 2009.

Grandfathering will also allow new instruments to be developed that are consistent with revised capital recognition criteria. In this regard, we emphasise that development of new capital products and their acceptance by investors will take time. This should be taken into account when determining appropriate transition and grandfathering periods.

As part of the proposed grandfathering arrangement, it is important that the Committee give consideration to the *amounts* of hybrid capital that may be recognised under the framework over the grandfathering period. In this regard, the ABA supports an approach that specifies the amounts of hybrid capital eligible for inclusion as a percentage of Tier 1 capital and gradually reduces the allowable percentage over time. Such an approach would provide for a level playing field across banks in relation to allowable hybrids, particularly given that current regulatory limits in relation to Tier 1 hybrid capital differ across jurisdictions.

<u>Main Recommendation 1:</u> The Committee's timetable should allow for further impact assessment and industry consultation. Implementation of the final changes should be phased and globally consistent and capital instruments grandfathered.

The ABA is concerned that the completeness and integrity of the policy setting process is being compromised by the aggressive timetable that has been set by the G20 Leaders. To ensure that the final changes will support the industry over the longer term, the ABA recommends that there be further industry consultation, debate and challenge globally once the Committee's impact analysis is complete. The process that the Committee is working through should also take account of the complex inter-linkages between the various elements of the proposed revised capital adequacy framework. To do this, the ABA recommends that the Committee adopts a phased approach to policy development that determines first some of the core components of the framework, such as the definition of capital and the prudential treatment of provisions and expected loss, before determining other components of the framework that depend on some of the aforementioned components (such as minimum capital requirements and measures to dampen pro-cyclicality).

The ABA recommends a globally consistent approach to implementation. It is essential that all jurisdictions implement the changes at the same time to minimise market confusion and misinterpretation, facilitate comparability and market discipline and ensure a level playing field across banks. Depending on the shape and form of the final framework, the approach may need to be phased to avoid adverse macroeconomic outcomes. Grandfathering periods should be similarly consistent across jurisdictions and take effect from the time that the framework is implemented. Further, the ABA recommends an approach that specifies the amounts of grandfathered hybrid capital eligible for inclusion as a percentage of Tier 1 capital with the allowable percentage gradually reduced over time.

2.3 Alignment between regulatory and accounting frameworks

The Resilience Document refers to international and local accounting frameworks in the context of capital instruments as well as in relation to the leverage ratio and forward-looking provisioning. We make a number of observations here in relation to the inter-dependency between regulatory and accounting frameworks. Many of these observations recur in other sections of this submission; here we make some overarching remarks.

First, we highlight that there exist fundamental differences in the objectives of the regulatory and accounting frameworks, the former being focused on future bank solvency and the latter on bank performance and current financial position. These differing objectives shape the requirements of both regimes and necessitate different targets and measures. For this reason the ABA is of the view that it will not be possible to fully align regulatory and accounting frameworks and does not make sense to do to so. Instead, we suggest that dialogue with the International Accountings Standards Board ('IASB') focus on ensuring that accounting standards are constructed in such a way so as facilitate identification and quantification of the regulatory adjustments that would be required to meet the objectives of the regulatory framework. This will assist regulators and the market to compare regulatory outcomes across countries, reducing reporting complexity, investor uncertainty and, potentially, incentives for inappropriate behaviours by banks.

Second, consistent with the above comment, we suggest that the Committee work with the IASB to develop consistent terminology and methodology. There are numerous examples where the same terms (such as expected loss) are used in different ways under the two frameworks, giving rise to market confusion that no amount of disclosure will be able to resolve given the complexity of the issues.

Third, the Resilience Document includes in the proposed criteria for Tier 1 Capital, references to local accounting treatment as the determining factor for meeting the criteria. Given differences in accounting frameworks across jurisdictions, and the Committee's objective of developing a globally harmonised capital framework, it may be preferable for the Committee to explain the objective of the criteria rather than rely on reference to the accounting framework.

<u>Supplementary Recommendation:</u> Notwithstanding their different objectives, the regulatory and accounting frameworks should adopt common definitions and methodologies to facilitate reconciliation between the two frameworks to the extent that they overlap.

The ABA is of the view that complete alignment of the regulatory and accounting frameworks is not feasible given their differing objectives and not necessary in any case. Hence, the ABA recommends that the frameworks, to the extent possible, adopt common definitions and methodologies including for capital deductions. This should allow identification and quantification of required regulatory adjustments in bank financial accounts such that these can be simply and transparently calculated using standard outputs of the financial accounts.

2.4 Releasing the final framework: "announcement risk"

When the final regulatory framework is released, the market's assessment of how individual banks fare under the new rules will be immediate (i.e. how much

additional capital banks will be required to raise or additional liquid assets they will need to fund). Depending on the final rules, this assessment may have significant adverse implications for banks' financial positions by way of share price adjustments. It is likely that markets will expect banks to hold, with immediate effect, capital and liquidity required under the revised framework, regardless of the period over which the requirements will be phased-in. The ABA is of the view that likely market responses to the framework should be considered by the Committee as part of the Committee's impact assessment.

The release will also invoke an immediate response in financial markets. Australia's experience on releasing a draft consultative paper on a liquidity risk management framework in September 2009 provides some, albeit small, insight into the potential for significant and immediate financial market response in anticipation of longer term change.[5] Jointly, the responses of the equity and debt markets to banks' financial positions and the responses of financial markets to longer term supply and demand for financial instruments may have broader implications for the effective functioning of local and global economies. Compounding these outcomes is a significant risk that the regulatory framework or its implementation may be misinterpreted by markets.

While the responses of analysts and markets are largely autonomous, it is important that they are anticipated such that the risk of adverse outcomes is at least known in advance. Similarly, it is important that misinterpretations by the market are avoided by putting in place an appropriate internationally co-ordinated market communication framework to be followed by national supervisors to explain to analysts and investors the detail of the changes and their impacts on banks and the process worked through to determine the final regulatory framework.

<u>Supplementary Recommendation:</u> An internationally consistent communication strategy is required to minimise over-reaction and misinterpretation by markets.

The ABA recommends that the Committee give consideration to the announcement risk that will arise on release of the final standards, including recognition and assessment of the likely market responses to the final standards. The ABA recommends that the Committee work with industry to develop an internationally co-ordinated communication framework for consumption predominantly by analysts and investors that mitigates the risk of over-reaction and misinterpretation by the market.

3. International consistency

In principle, the ABA supports the Committee's focus on the introduction of an internationally harmonised regulatory framework. Successful implementation of a

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[5] The ABA observed a number of market responses following release of APRA's liquidity proposals in September 2009 (Refer APRA Discussion Paper *APRA's prudential approach to ADI liquidity risk* 11 September 2009). These included a material change in the price differential between physical bonds and the bond futures contract reflecting greater demand for physical securities. The market changes experienced reflected expectations of lower demand for bank bills, higher demand for physical bonds and more offshore term issuance by banks.

consistent regulatory framework to banks across all jurisdictions will ensure a minimum level of resilience and reduce opportunities for capital arbitrage. It will also facilitate comparability across banks in different jurisdictions and in so doing lend support to the principle of market discipline. Comparability across banks, and across jurisdictions, is particularly important in the case of capital given the role that relativities play when investors, and regulators, assess bank capital strength.

It may not always be possible, however, to develop detailed internationally harmonised regulatory requirements owing to structural or other differences in local jurisdictions. It should be possible to develop a regulatory framework based on clearly articulated objectives and principles. Within this, national supervisors should have the flexibility to implement the framework in a manner that meets the objectives of the framework while responding to the constraints or impediments posed by the local environment, including local market and economic conditions, as well as local taxation, accounting and legislative requirements.

For the *definition of capital*, a consistent regulatory capital framework is more feasible given that capital is a largely homogenous construct and is not dependent on local financial markets and economic conditions. While differences in accounting, legislative and taxation frameworks will impact how requirements are interpreted by national supervisors, and how capital instruments are viewed by capital providers, for the most part the definition of the capital base, and its associated deductions, should be implemented consistently around the world.

There should therefore be minimal national discretion, except to the extent that national discretion is necessary because of the local environment to achieve the objective of the regulatory framework. This is especially the case if the framework is broad, simple and, importantly, transparent.

Simplicity and transparency will be facilitated by a capital framework that provides internationally-consistent definitions. A simpler framework would be assisted by streamlining the complex scheme of regulatory capital adjustments such that these are consistent across jurisdictions. The ABA agrees with the Committee's observation that there is currently "no harmonised list of regulatory adjustments...undermining the consistency of the regulatory capital base." In particular, the definition of the capital base and its associated deductions (such as the treatment of dividend accruals) should be able to be implemented consistently with minimal national discretion. Similarly, for measures of risk-weighted assets, it is important that the regulatory framework adopt consistent methods for measuring risk (this includes the consistent capture and disclosure of risks such as interest rate risk in the banking book being in Pillar 1 or Pillar 2). Consistent definitions of capital and consistent measurement methods for risk-weighted assets will facilitate useful comparisons by markets of the relative capital strengths of banks across jurisdictions.

In line with this, the ABA is concerned by the Committee's reference to a "minimum set" of adjustments which suggests that national supervisors may choose to apply additional deductions at their own discretion. Such an outcome appears inconsistent with the objective of harmonisation and transparency. The ABA is of the view that the set of regulatory adjustments should be a consistent

set such that the definition of the capital base is consistently, simply and transparently applied across jurisdictions.

Main Recommendation 2: The regulatory framework for capital should be based on clearly articulated objectives and principles so as to achieve a consistent level of resilience. Discretion exercised by national supervisors on the definition of capital can and should be kept to a minimum. National supervisors' implementations of the framework should be transparent and readily justified.

The ABA recommends that the regulatory framework be based on clearly articulated objectives and principles that allow national supervisors to implement the framework in a manner that meets the objectives of the framework while responding to the constraints or impediments posed by the local environment, including local market and economic conditions, as well as local taxation, accounting and legislative requirements. To maintain consistent standards across supervisors, we recommend that the framework require national supervisors to explain, by way of local prudential policies, the linkages between the principles laid out by the Committee and national supervisors' local implementations of those principles in the context of jurisdiction-specific factors.

4. Pillar 2 measures

The regulatory changes are focused heavily on additional prescriptive regulation under the realm of Pillar 1 minimum capital requirements. While we agree that additional regulation is warranted and strongly support the need for a consistent "base level" of comparative information on relative bank capital strength as part of Pillar 1, we emphasise the importance of improved supervisory analysis and challenge as part of national supervisors' Pillar 2 regimes. Undue focus on Pillar 1 may have the unintended consequences of less rigorous challenge by supervisors and the application of a "one size fits all" approach that is not tailored to the riskiest or most vulnerable components of a bank's activities and which penalises lower risk banks.

Consistent with the Basel II framework, a robust framework developed as part of Pillar 2 should encourage national supervisors to tailor review processes to suit each bank's risk profile and encourage banks, themselves, to develop internal capital assessment processes (including the setting of capital targets) that align with their risk appetites. We emphasise that implementation of supervisory tools as part of Pillar 2 should not reduce the role that these tools play in the supervisory framework nor the scrutiny or importance placed by national supervisors on the applications of these tools.

4.1 Leverage ratio

The Consultative Document proposes the introduction of an internationally-consistent leverage ratio to facilitate comparisons of bank leverage across jurisdictions. This follows a view by the Committee that excessive leverage was a driver of the GFC and that deleveraging amplified downward pressure on asset prices, compounding pro-cyclicality. The objective of the leverage ratio is to constrain excessive leverage and limit model risk and measurement error by providing an independent measure of risk that is based on gross exposures.

The ABA acknowledges the value to the market of having in place a simple measure of leverage that facilitates comparisons across banks and provides a transparent "floor" that is not clouded by complex risk measures and modelling tools. This floor can serve as a replacement to the existing transitional floor and we recommend that the leverage ratio replace the transitional floor rather than supplement it.

However, we note that the ratio proposed is neither simple nor transparent. Much of the difficulty comes from the considerable divergence in accounting treatment of items that feed the leverage ratio calculation and have a significant impact on outcomes. Comparability of the leverage ratio across jurisdictions is essential as well as the transparency of the calculation of the numerator and denominator (including any adjustments made).

There is also a significant risk that leverage ratio outcomes will not be appropriately interpreted by the market, compressing and/or distorting relative outcomes between banks by not differentiating between the riskiness of particular asset types nor recognising the benefits of credit risk mitigation. Over-reliance on leverage ratio outcomes may distort the markets' ability to assess relative riskiness between banks, leading to some banks' risk profiles being under-stated relative to others as a consequence of leverage ratio interpretations.

The ABA is therefore of the view that the leverage ratio should not replace risk based capital assessment as the cornerstone of the supervisory framework. The ABA is strongly of the view that the leverage ratio be implemented as a Pillar 2 tool rather than a Pillar 1 regulatory constraint. This will allow the information that flows from the leverage ratio to serve as a useful challenge and "second check" of Pillar 1 outcomes without the risk of over-reliance by regulators and the market as a key measure of risk. Implementation in Pillar 2 also addresses potential issues from significant variation in accounting frameworks and the consequent risk of misinterpretation by the market. In our view, the leverage ratio works best as a monitoring tool for supervisors in their Pillar 2 review processes.

We note that the Committee has not, to date, set a fixed outcome or cap on the leverage ratio. This is a sensible approach and recognises that the bluntness of the tool is such that its value must be determined by national supervisors on a bank-by-bank basis. To do otherwise may distort market and supervisors' assessments of the relative riskiness of banks within and across jurisdictions.

We understand that the Committee is considering whether certain high quality liquid assets, based on the liquidity framework definition, should be excluded from the measure of exposure in the leverage ratio calculation. The ABA notes that the leverage ratio is intended as an indicator of the health of a bank's balance sheet (and, importantly, a bank's off-balance sheet activities). In this regard, the focus on leverage should be one of capital to "risk assets", that is, the leverage of capital to generate asset returns. We are therefore of the view that the measure of exposure in the leverage ratio should be limited to those assets that give rise to risk of unexpected loss. We do not believe that high quality liquid assets should form part of the leverage ratio calculation. In a similar vein, the ABA is of the view that Common Equity is the most appropriate measure for the purpose of calculating the leverage ratio given that Common Equity is the purest form of capital. Due to differences in local rules having a more significant

impact on other components of capital relative to Common Equity, the use of Common Equity is also likely to assist in ensuring a more globally consistent base.

In relation to the treatment of securitisation exposures, we would not support adoption of an accounting approach given the lack of international harmonisation for securitisation accounting. For simplicity, we are of the view that all securitised loans are to be included in the gross exposure measure regardless of whether the underlying assets are "on" or "off" balance sheet. Under IFRS, Australian banks are generally required to keep securitised loans on balance sheet, in contrast to some other jurisdictions such as Canada.

4.2 Procyclicality

4.2.1 Cyclicality of the minimum capital requirement

The ABA agrees with the Committee's objective of reducing the extent of procyclicality in banks' minimum capital requirements. However, the view of the ABA is that while procyclicality in a broad sense has been a significant issue during the GFC, there is little evidence to suggest that the Basel II advanced approaches materially increased procyclicality in banks' capital requirements. In this regard, we note that the Committee is gathering information on the extent that the regulatory capital requirements added to cyclicality during the GFC. We request that the Committee make that information available prior to finalising any changes to the existing requirements.

The ABA also notes that the Committee has reviewed a number of measures that supervisors could take to achieve a better balance between risk sensitivity and the stability of capital requirements and is conducting an impact study on two specific proposals. (The ABA understands that these draw on, but are not precisely the same as proposals explored by the Committee of European Banking Supervisors and the UK Financial Services Authority.) The ABA welcomes the opportunity to comment in detail on the framework once more concrete proposals are developed. In the meantime, we make some preliminary observations on the two specific proposals included in the Resilience Document.

At the outset, we acknowledge that approaches should, at least partially, achieve the goal of a more stable minimum capital requirement.

The ABA notes that, in practice, the underlying credit quality of a bank's portfolio changes over time, as does the risk estimate methodology. However, even in a portfolio where the underlying credit quality does not change and there are no changes to the risk estimate methodology, the application of a scalar based on exposure classes could lead to outcomes quite different to the use of true through-the-cycle (TTC) probability of default (PD) estimates at the individual obligor level. In practice, changes in average PD are typically driven by a small proportion of the portfolio experiencing a relatively dramatic re-rating. Risk grades for the bulk of the portfolio tend to remain relatively stable. Thus, while the use of a scalar will dampen cyclicality to some degree, it will not eliminate it.

There are some particular conceptual concerns relating to the second proposal, that is, a scalar based on an average of historic PD estimates for each exposure class. The ABA has assumed that the intent is to make the application of downturn PD assignments the benchmark for the TTC level of PDs. Such an outcome appears inconsistent with the Basel II capital formula that is based on a

99.9 per cent confidence interval on possible PD outcomes and is parameterised with reference to an average PD for each rating. The use of a downturn PD is clearly more conservative but comes at the cost of clarity and transparency and does not seem to be related to the issue of procyclicality or volatility of the minimum capital requirement. If a consistently more conservative overall capital outcome were the goal (as opposed to the stated goal of a reduction in volatility of the minimum capital requirement) then the natural way to achieve this, without distorting the understanding of the model, would be to simply increase the confidence level.

A further concern is the behaviour of this mechanism in a severe downturn. If in a future downturn assigned PDs exceed the previous peak levels, it would seem that at that time (precisely the time when procyclicality is likely to be the greatest concern) banks would again become fully exposed to the current degree of potential 'upside' in minimum capital requirements.

The use of a scalar based on historical-assigned PD estimates at the exposure class level raises a couple of further issues. Combining cyclical (migration driven) changes in credit quality with other factors, including fundamental changes in the underlying credit quality of the portfolio (changes to underwriting standards, target markets, ageing of the portfolio etc) and changes in risk estimates and risk estimate methodology, may lead to significant mis-statements of current portfolio risk. There is also the challenge arising from potential differences in data histories between banks – it would be an unsatisfactory outcome if differences in the availability or reliability of historical data series drove differing minimum capital outcomes across banks with fundamentally similar portfolios.

4.2.2 Building buffers through capital conservation

The ABA accepts that capital should be conserved when Tier 1 Capital approaches the regulatory minima. We believe strongly however that primary responsibility for bank capital management rests with a bank's board. We argue it is the role of a bank's board, through the bank's own internal capital adequacy assessment process (ICAAP), to manage the proximity of capital held to the regulatory minimum. We do not believe that this is the role of the regulatory process, but the ABA recognises that supervisors have a legitimate role in challenging the decisions of banks and should have the power to react if considered necessary.

That observation aside, given the difficulty in forecasting the length and severity of economic downturns, the ABA believes it would be difficult for bank management and regulators to be comfortable about running down capital levels during a downturn. Further, the ABA has reservations as to whether market behaviour will allow the proposed capital buffers to work as intended. As observed in the Resilience Document, experience during the GFC and earlier periods of stress has shown that during such periods the market expects banks to increase capital, and even "over-capitalise", in order to provide an additional margin of safety.

As evidenced during the GFC, capital conservation and cyclical buffers buy banks some time to respond to the stress; however the market typically demands a rapid replenishment of capital - significantly more rapid than could be achieved by withholding dividend distributions alone. The ability to be able to respond effectively to this market discipline depends on a bank's contingency planning arrangements and other elements of capital management flexibility built into the

bank's risk appetite statement and the ICAAP. A Pillar 1 treatment, by definition, tends to constrain the flexibility that is essential for successfully responding to a stressed environment.

Notwithstanding the above reservations, the ABA understands that the concept of capital conservation has considerable support. Should the Committee decide to proceed with the concept of capital conservation, the ABA makes the following comments.

Given our reservations about the market reaction to any use of the buffers, the ABA believes that the best chance of gaining market acceptance would be for the buffer to be specifically identified as a counter-cyclical buffer rather than being subsumed within the overall pool of core Tier 1 capital. Consequently, it is very important that there be a high degree of transparency on what Tier 1 minimum the buffer is intended to protect and what severity of downturn it is intended to be capable of absorbing.

The Committee has indicated that it will consider appropriate minimum capital requirements as part of the impact assessment that is currently under way. It is critical that regulatory minima be calibrated high enough to be credible but not so high that in combination with conservation and cyclical capital buffers they effectively force banks to hold more capital due to overlaps between multiple layers of conservatism.

The Committee has acknowledged the challenges in recalibrating the capital framework to provide for cyclical buffers, but notes that the buffer must be sufficiently large to enable banks to remain above the minimum requirement in the face of losses expected to be incurred in a feasibly severe downturn. The ABA recommends that the Committee consult widely on this issue and remain cognisant of the implications of banks being "over-capitalised" and effectively holding higher levels of capital over the course of the cycle.

We believe that the appropriate supervisory response to the GFC is increased emphasis on existing Pillar 2 tools. Pillar 1 implementation would suggest a "one-size-fits-all' approach to the size of the capital buffer. This would clearly be inappropriate in that the capital buffers should reflect the potential volatility in a banks' minimum capital requirement which, in turn, will depend on the bank's own risk profile and on the potential procyclicality of the bank's portfolio. The ABA is also of the view that a mechanistic approach to the determination of capital buffers transfers a significant element of responsibility for capital management from bank boards to regulators. A Pillar 2 approach will allow alignment with banks' own capital management processes and will avoid application of a mechanistic approach to capital management that is not commensurate with the risks that bank capital is intended to support.

As we have outlined earlier, the implementation of supervisory tools (such as the leverage ratio and capital buffers) as part of Pillar 2 should not reduce the role that these tools play in the supervisory framework nor the scrutiny or importance placed by national supervisors on the applications of these tools. In this regard, the ABA draws attention to a mechanism that appears to be working successfully in Australia and which could be expanded to also specifically address capital conservation. APRA sets a bank specific prudential capital ratio (PCR) for each bank that can be no lower than the 8 per cent set by the Basel II Framework. The PCR takes into account risk factors that have not been incorporated or

accounted for in the risk-based capital adequacy framework. In addition to specific risk factors, such as credit concentrations, the PCR is also set by reference to the effectiveness of a bank's management systems for monitoring and controlling risks. The starting point for the PCR is a bank's ICAAP. While the PCR and Tier 1 minimum must be met at all times, there is no limitation on how frequently they can be changed. The PCR is confidential between APRA and the bank. That of course reduces transparency and would make consistency, especially between supervisors, problematic. The advantage, however, is that it can be changed without regard to the market and any market reaction.

Main Recommendation 3: The revised regulatory framework should make more effective use of Pillar 2. The simple leverage ratio and capital buffers should form part of the Pillar 2 framework. Irrespective, capital buffers should be identified separately to minimum capital requirements.

The ABA emphasises the importance of improved supervisory analysis and challenge as part of national supervisors' Pillar 2 regimes and recommends that the leverage ratio and capital buffers form part of supervisors' Pillar 2 frameworks. In line with the Basel II framework, Pillar 1 provides for a minimum level of required capital in banks that facilitates comparison across jurisdictions. Pillar 2 allows supervisors to adjust regulatory capital, as determined by Pillar 1, to ensure its appropriateness for the risk profiles of individual banks.

Consistent with this thinking, the ABA recommends that the leverage ratio be implemented as a Pillar 2 measure. While we acknowledge the value of a simple measure of leverage that facilitates comparisons across banks that is not clouded by complex risk models, the bluntness of the tool and the significant variation in accounting frameworks across jurisdictions is such that its value must be determined by national supervisors on a bank-by-bank basis and should not replace risk-based capital as the foundation stone of the supervisory framework.

Similarly the ABA recommends that capital buffers introduced to dampen pro-cyclicality should form part of the Pillar 2 framework. It is important that these buffers are specifically identified as separate from the minimum capital requirement and not subsumed within the overall pool of core Tier 1 capital. Moreover, all three counter-cyclical buffers proposed by the Committee, namely those relating to cyclicality of the minimum capital requirement, capital conservation and excessive credit growth, should be considered collectively in determining an appropriate overall capital buffer in excess of the minimum capital requirement.

To maintain a consistent minimum level of soundness across jurisdictions, Pillar 2 implementation should be accompanied by adequate supervisory disclosure and be subject to the peer review processes that have been proposed by the Financial Stability Board.

4.2.3 Excessive credit growth

The ABA accepts that the concept of regulators having more tools to dampen economic cycles is reasonable, but believes that in practice the Committee proposals will be difficult to implement. The Committee has acknowledged that the proposal is at an early stage of development.

The ABA believes that the identification of excessive credit growth is difficult given that at times strong growth can reflect rational expectations of future strong income growth.

The ABA questions whether the issues that are being identified require new regulatory tools, or whether the existing regulatory tools are sufficient. Proposals to address excessive credit growth appear to be driven by increases in financial intermediation leading to banking activities representing an increasing proportion of GDP, increased leverage and an increase in loans motivated by expectations of increases in asset (mainly property) prices.

The ABA does not dispute the rapid increase in financial intermediation (by banks), but does question whether there is anything intrinsically wrong in that. Also, to some extent the increased role of banks simply reflects changes in the structure of the broadly defined financial system.

The ABA also acknowledges that both the "retail" (especially) and corporate sectors have taken on greater leverage. The concern appears to be the impact of an economic downturn on that increased leverage. The ABA submits, however, that the real basis of the concern should be bank lending standards and that regulators already have sufficient tools to address any weakening of such standards.

It is true that much of the increased lending by banks is accounted for by retail mortgage lending. The motivation of borrowers to acquire property should not be a concern of banks. What should concern banks and their regulators is how the loan is assessed. Repayment of a loan that depends on the security property increasing in value does not have the same risk factors as a repayment that depends on the ability of the borrower to service an amortising loan. Regulators already have the tools to address such matters as inappropriate lending standards and to make regulatory capital more sensitive to loan-to-valuation ratios.

4.2.4 Forward-looking provisioning

The ABA notes that the Committee is advocating a change in the accounting standards towards an expected loss approach, but the ABA has reservations as to whether accounting standard setters will ever align their objectives, which are currently point-in-time, with those of prudential supervision. That is, the proposed accounting rules seek to ensure that financial results and positions are accurately reported as at a specific date, whereas bank regulators are seeking to ensure that banks hold sufficient capital such that they can continue as a going concern.

It is understood that an expected loss accounting provision would be based on current economic conditions, but financial regulators require a stressed loss given default. In other words, the proposed new accounting provisions can still result in a procyclical outcome when economic conditions change.

The ABA believes that a preferable approach would be to work with the accounting standard setters to ensure that financial statements are constructed in such a way that facilitates reconciliation from accounting provisions (i.e. via regulatory adjustments) to prudential provisions.

Further, the current regulatory approach appears to be intended to produce a "downturn" expected loss ("EL") rather than a true "through the cycle" EL. To the extent that regulatory EL remains a downturn estimate, it will not be a meaningful benchmark for loan loss provisioning and the goal of alignment with the accounting standards is likely to be difficult, if not impossible, to achieve. The Committee should therefore base its EL calculation on realistic "through the cycle" estimates of PD, LGD and exposure at default and separately address downturn considerations through the calibration of capital buffers to the desired levels of downturn resilience. We also note that any residual prudential concern with inadequate loan loss provisioning appears to be addressed by the proposed Tier 1 deduction for EL shortfalls.

Supplementary Recommendation: Loan loss provisions in the financial accounts should be defined and constructed to facilitate simple determination of the required regulatory adjustments.

Consistent with earlier comments, the ABA recommends that loan loss provisioning in the financial accounts be defined and constructed in a manner that facilitates the simple and transparent determination of the required regulatory adjustments. This would be achievable to the extent there was consistent use of Basel II PD and LGD estimates in both standards although approaches may also be available that facilitate a simple and transparent reconciliation between the two measures of loan loss.

We recommend that the Committee also review its regulatory definition of expected loss (EL). To the extent that regulatory EL remains a downturn estimate it will not be a meaningful benchmark for loan loss provisioning and we recommend that the Committee base its EL calculation on realistic "through the cycle" estimates of PD, LGD and EAD. Downturn considerations should be separately addressed through the calibration of capital buffers to the desired levels of downturn resilience. The proposed Tier 1 deduction for EL shortfalls should address any concern with inadequate loan loss provisioning.

5. Definition of the capital base

5.1 Determining the quantum of capital

The Committee's proposals note that market pressure has already required increases in the level and quality of capital and that the proposals are intended to ensure that these gains are maintained over the long run. While we understand that the output of the impact study will in large part determine changes in *required minimum* levels of capital, the ABA is strongly of the view that the revised framework should not have as an objective, to increase the *actual* levels of capital held by the banking sectors in all individual jurisdictions. We note that the levels of Tier 1 Capital held by Australian banks currently are relatively high, in large part owing to the existing Australian regulatory capital framework.

5.2 Overarching comments on eligibility criteria for capital instruments

The ABA supports the Committee's objectives of simplifying the regulatory capital base and improving its quality, consistency and transparency to absorb losses on both a going concern and gone concern basis.

The current regulatory capital framework is overly complex and, in some aspects, unnecessarily prescriptive. In the ABA's view, a prescriptive capital framework that "over-engineers" the capital rules promotes "capital arbitrage" by banks. The ABA recommends that the regulatory capital framework be based on principles and statements of substance rather than prescriptive rules that can be arbitraged. In so doing, the framework will encourage enhancements in the capital base that are consistent with the objective of improving the overall quality of bank capital and will limit opportunities for arbitrage which may not necessarily improve capital strength. The more the proposals focus on substance rather than form, the more likely that capital instruments will emerge to meet the intent of the framework.

5.3 Components of capital

5.3.1 Capital structure

The ABA supports the three-tier capital structure that is proposed in the Resilience Document as well as the proposal that Common Equity be the predominant form of capital. Consistent with the comments made above, it is essential that the same capital structure, including the reliance on Common Equity, be applied across all jurisdictions and that all capital items are defined in substance rather than legal form or structure. In this regard, while we acknowledge that the Committee's assessment of "predominance" must still be worked through as part of the impact assessment and calibration process, it is important that the final determination be definitive and consistently applied across jurisdictions.

Along similar lines, it is also important that the regulatory approach to other Tier 1 capital instruments (often referred to as Tier 1 hybrid capital) be applied consistently across jurisdictions. Currently, regulators set very different portfolio limits on Tier 1 hybrid capital as a proportion of total capital. For example, the Australian regulator limits Tier 1 hybrid instruments to 25 per cent of Tier 1 capital as currently defined (innovative instruments are limited to 15 per cent). A simple, harmonised and transparent framework will clearly require alignment of the regulatory treatment and allowances for Tier 1 hybrid capital instruments. The ABA suggests that the Committee consider limiting Tier 1 instruments (other than Common Equity) to 25 per cent of Tier 1 capital.

5.3.2 Common Equity Component of Tier 1

The Resilience Document recognises Common Equity as the highest quality component of capital that should be the most subordinated claim in liquidation of the bank and absorb losses as and when they occur. Common Equity should also have full flexibility of dividend payments and contain no maturity date. The ABA agrees with the substance of Common Equity as set out in the Document.

5.3.3 Tier 1 Additional Going Concern Capital

The ABA supports recognition of additional capital items that are able to absorb losses while the bank remains a going concern. These capital items will serve to strengthen the capital base of a bank and provide a useful alternative source of capital funding. Consistent with earlier comments, the criteria for recognition as Tier 1 Additional Going Concern Capital should be described in terms of principles and objectives and without reference to legal form or structure, such as reference

to interpretation of accounting standards or conversion and write-down mechanisms.

The Committee's proposal to include as a criterion for Tier 1 Additional Going Concern Capital the need for principal loss absorption for certain instruments, through either conversion to common shares, or a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point (criterion 11), is potentially problematic given the role of these instruments in the capital structure – criterion 11 is discussed in more detail below. Tier 1 Additional Going Concern capital plays an important supporting role in the loss absorption process that is different from that of Common Equity. As currently drafted, the criteria for Tier 1 Additional Going Concern appear to be structured so as to ensure that these instruments imitate Common Equity as closely as possible, rather than play a supporting role in the loss absorption process.

The economic rationale for banks issuing Tier 1 Additional Going Concern structures has traditionally been perceived to rest largely on these instruments being a more cost effective source of Tier 1 capital than Common Equity. The willingness of investors to accept a lower return typically reflects their limited or nil entitlement to either capital appreciation or voting rights. Tier 1 Additional Going Concern capital holders logically are only willing to accept a lower return and less control to the extent that they hold a "preferred position" in the loss absorption chain. Regardless of the legal form, Tier 1 hybrid instruments issued by Australian banks to date have generally provided for a preferred ranking (i.e. preferred over common shares) while still being subordinated to depositors, general creditors and subordinated debt of the bank. Continuation of this preferred ranking appears to be permitted under criterion 2 of the proposed criteria. This position means that Additional Going Concern capital holders should be required to participate in losses, but only after Common Equity holders have first absorbed a material portion of the losses.

Criterion 7 for Tier 1 Additional Going Concern Capital requires that banks must have full discretion at all times to cancel dividends/coupons and that such a cancellation must not be an event of default. This criterion allows Tier 1 Additional Going Concern Capital instruments to absorb losses on a going concern basis by foregoing any dividends/coupons when required. Criterion 8 states that dividends/coupons should be paid out of distributable items, which is defined to include retained earnings. This may mean that banks may report a loss but are still able to pay out a coupon on these Tier 1 instruments. To further strengthen this loss absorbing characteristic, the ABA suggests that the Committee consider implementing a narrower definition of distributable items where capacity to pay distributions (without prior approval of the national regulator) is based on prior year reported earnings and does not include retained earnings. This is a test that is already in place in Australia that can ensure that the Tier 1 capital holders are forced to participate in losses in a going concern and do not receive a distribution if the bank has not recently reported a profit. We further note that capacity to pay may also depend on where a bank is positioned in relation to the capital conservation range.

In addition, the Committee proposes to require principal loss absorption for instruments classified as liabilities. Criterion 11 relating to principal loss absorption is repeated below:

- *instruments classified as liabilities must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point that, among other things, reduces the claim of the instrument in liquidation and the amount re-paid when a call is exercised.*

Australia's national insolvency law does not include a balance sheet test. Tier 1 instruments can be issued either as legal form equity (e.g. a preference share) or as legal form liability (e.g. a convertible note) but otherwise can have the same terms and subordination. Both instruments can perform the same role as going concern capital. Provided the terms are the same, the subordinated legal form liability will act in the same way as the legal form equity instrument and will not accelerate or bring forward insolvency. A legal form liability instrument that meets all of the proposed criteria for Tier 1 Additional Going Concern capital (other than criterion 11) should be distinguished from gone concern capital, as it can perform the same role as going concern capital. Accordingly, the ABA does not see a need for this criterion for these instruments.

Irrespective of this outcome, the rationale for application of the criterion only to liability classified instruments[6] is unclear and further clarification on the rationale for this approach is requested. If a principal loss absorption requirement is only relevant in those jurisdictions where national insolvency law includes a "liabilities-greater-than-assets" balance sheet test, this should be clarified in the revised framework, such that it is applied only to securities that would otherwise fail the requirements of criterion 10.

To the extent that loss absorption of principal is retained as a general criterion of Tier 1 Additional Going Concern capital, the fundamental question for Tier 1 Additional Going Concern capital instruments is how to define exactly where the trigger point for principal loss absorption should be set to allow such capital to fulfil its economic purpose. In principle, the thresholds and triggers should be calibrated to large or sustained losses that represent low probability (i.e. high confidence level) events to ensure that common equity holders have borne some losses before these instruments are subject to principal loss absorption.

Defining the triggers is difficult, and is about striking the right balance between the interests of Common Equity and Tier 1 Additional Going Concern capital holders. If the triggers are set such that the loss absorption features of Tier 1 Additional Going Concern capital align too closely with Common Equity, then Tier 1 Additional Going Concern capital will be extremely limited as a viable instrument in capital markets – coupling a high risk of principal loss absorption with no capital appreciation capacity will mean that holders will expect returns

[6] The ABA understands this "liability" reference is intended to refer to legal form rather accounting treatment. It is noted however that this intention was not clear and caused some confusion.

exceeding ordinary shares for accepting the risk, which will not be acceptable to issuers.

Development of the criteria should be principles based (to allow implementation under different legal, tax and accounting and market conditions) and we recommend that the principle rather than the mechanism be required in the framework. To the extent that this criterion remains, we recommend that conversion into common shares, rather than a write-down mechanism, be adopted. Moreover, this conversion should be to a variable rather than fixed number of common shares, to avoid exposing the capital instrument holder to share price volatility (and loss of principal) ahead of the conversion[7]. Provided the trigger point is set appropriately, there should be no regulatory requirement for principal loss absorption to occur ahead of the instrument conversion being triggered. The ABA suggests that a variation of the example of Mandatory Convertible Structures (MCS) that have been issued over the past few years in Australia may be a feasible structure. These instruments:

- Meet all of the criteria in paragraph 89, other than criterion 11;
- Generally provide for automatic conversion in ordinary shares of the issuer after five years. A pre-specified trigger point can be added to the structure to trigger conversion into ordinary shares when the trigger point is reached (e.g. trigger could be the publicly stated minimum Core Tier 1 level plus a buffer);
- The number of ordinary shares to be issued is variable but subject to a cap i.e. the number of shares to be issued is calculated with reference to the volume weighted average price (VWAP) of the shares in the market immediately prior to conversion, but subject to a cap on the number that can be issued[8]. The cap will help avoid the unlimited dilution of ordinary equity holders that may interfere with recapitalisation or refinancing - the 'death spiral' where issuance of ordinary shares puts further pressure on share price.

The Resilience Document also notes that certain innovative features which over time have been introduced to Tier 1 will need to be phased out. We highlight that there is currently confusion as to which innovative instruments or features will be phased out over time and seek clarification from the Committee on this point.

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[7] If the share price on conversion is set at the time of issuance (such that the conversion is to a fixed number of shares), the instrument's value would vary in line with share price movements and hence the instrument holder would be exposed to the same potential going concern losses as holders of Common Equity. If the share price on conversion is derived from the share price immediately prior to conversion (such that the conversion is to a variable number of shares that depends on the share price), the holder will only be exposed to loss of principal from the time that conversion is triggered.

[8] In Australia, the current cap on the number of shares that can be issued on conversion is calculated by reference to the 50 per cent of ordinary share volume weighted average price prior to the initial issuance of the instrument, i.e. if the ordinary share price of the issuer has fallen by more than 50 per cent over the period since the instrument was first issued, the cap will take effect.

The Committee is specifically seeking feedback on whether the criteria proposed for the use of call options in Tier 1 Additional Going Concern capital items are sufficient to ensure that a bank is not expected to exercise a call unless it is in the bank's economic interest to do so. Consistent with our earlier comments in relation to substance over form, we believe that the criteria specified are sufficient for this purpose. The ABA also seeks clarity as to the rationale for the requirement that calls not be made within 5 years. It may be in the interests of the bank to call the instrument within 5 years. We note that these restrictions do not apply to Common Equity where, with approval from the appropriate regulators, it is possible to generally conduct share buy-backs at any time.

Additionally, it is common for Tier 1 hybrid structures to include call rights for the issuer in the unlikely event of a tax, regulatory or accounting change. We do not believe that an absolute prohibition on calls within the first 5 years is appropriate in these circumstances. To the extent that material changes to regulatory, legal, tax or accounting rules occur that would significantly impact either the issuer or the purchaser, it may be appropriate that an instrument is called or restructured.

<u>Main Recommendation 4:</u> The role of Tier 1 Additional Going Concern capital should be clarified, including that a principal loss absorption mechanism only apply in those jurisdictions where it is required by national insolvency law.

The ABA is of the view that Tier 1 Additional Going Concern capital should only absorb losses once Common Equity has first absorbed a material portion of losses. To require otherwise would not be economically viable for Tier 1 Additional Going Concern capital holders. The criteria proposed in the Resilience Document are not consistent with this philosophy; hence the ABA seeks clarification from the Committee as to the relative roles of Common Equity and Tier 1 Additional Going Concern capital in absorbing loss. The Committee's proposal to include, as a criterion for Tier 1 Additional Going Concern capital, a requirement for principal loss absorption is potentially problematic, depending on where the trigger point for loss absorption is set. In our view, inclusion of a mechanism to achieve principal loss absorption may only be relevant in those jurisdictions where national insolvency law includes a "liabilities-greater-than-assets" balance sheet test. We recommend that the principle rather than the mechanism be required in the framework. To the extent that this criterion remains, we recommend that conversion into common shares, rather than a write-down mechanism, be adopted and that conversion be to a variable rather than fixed number of common shares, subject to a maximum dilution floor, to avoid exposing the capital instrument holder to share price volatility (and loss of principal) ahead of the conversion.

5.3.4 Tier 2 Gone Concern capital

The proposed capital framework allows recognition of Tier 2 capital instruments to absorb losses on a Gone Concern basis. It is proposed that Tier 2 capital will need to meet the minimum standard of being subordinated to depositors and general creditors. It is further proposed that Tier 2 capital has an original maturity of at least 5 years and be "amortised" on a straight line basis during the final 5 years to maturity.

The ABA supports the objective of simplifying Tier 2 capital and eliminating sub-categories of capital, and recognises the value of Tier 2 capital as an additional

capital item to absorb losses in the event of bank failure. The ABA believes that use of an amortisation schedule is inconsistent with the concept of Tier 2 capital being used for the purpose of loss absorption on a Gone Concern basis, particularly when coupled with the requirement that Tier 2 capital not be allowed to be called without supervisory approval and not within 5 years of issue. The ABA therefore recommends that Tier 2 capital items be recognised in the capital framework at their full values until they are called.

5.3.5 Contingent capital

We note that the Committee is continuing to review the role that contingent capital, convertible capital instruments and instruments with write-down features should play in the regulatory capital. The ABA supports, in principle, the concept of contingent capital. We highlight, however, that there are many practical difficulties in relation to definition and application that may outweigh the benefits of recognising a contingent capital framework. The difficulties could work against the Committee's objectives of simplicity and transparency. Key considerations include the viability of the market for contingent capital, including pricing, and the implications of contingent capital for other key performance metrics such as Earnings per Share.

Clearly, further work is required to better understand the role that could be played by contingent capital and the market implications of developing these types of products. In any case, we are strongly of the view that decisions about whether a bank should hold contingent capital should be at the discretion of an individual bank and not a regulatory requirement.

5.4 Capital deductions

The Resilience Document observes that inconsistencies in the definition of capital and capital deductions across jurisdictions inhibit the ability of the market to fully assess and compare the quality of capital between banks. It therefore proposes to harmonise deductions internationally and, in general, to apply them to Common Equity. In general, the ABA agrees with this approach in the interest of simplicity, harmonisation and transparency.

However, the ABA believes that the Committee's proposed approach to capital adjustments for certain assets, such as capitalised software expenses, deferred tax assets and investments in non-consolidated insurance entities should be reviewed. All of these assets will have value on a going concern basis. We make the following specific comments in relation to these deductions:

- For capitalised software expenses and deferred tax assets, on a gone concern basis their values will be zero, but they will retain value (albeit potentially less than full value) while the bank remains a going concern.
- The value of net tangible assets for investments in non-consolidated insurance entities will under most circumstances be something greater than zero on both a going and gone concern basis. While we acknowledge the Committee's concerns in relation to the "double counting of capital" we are of the view that these concerns are better addressed outside of the Pillar 1 framework, the focus of which is the capital strength of individual banking groups.

In the interest of simplicity, we recommend that the Committee adopt, for capitalised software expenses and deferred tax assets, and retain for investments in non-consolidated insurance entities, a 50/50 Tier 1/Tier 2 approach. This will assist in aligning the approach for deductions to the broader philosophy of the Committee's proposed three-tier capital structure. A more sophisticated approach to deductions could be adopted although this may compromise the Committee's objectives of simplicity and harmonisation.

We also highlight that the changed approach will impact some banking groups more than others. It is therefore important that the implications of the approach to deductions be taken into account when assessing banks' overall regulatory capital holdings. The ability of banks to respond to the changes, by way of changing their investments or banking structure, is limited and the consequences for overall capital holdings may be significant. Accordingly, we recommend that the outcomes of the impact assessment be considered in the context of how the changes will impact economic activity in the short to medium term.

We note that the proposals do not address the treatment of dividends in the regulatory capital framework. Australian regulatory requirements specify that "expected" but undeclared dividends (net of expected dividend reinvestments) be deducted from Tier 1 capital, notwithstanding that they are not accounted for as accrued dividends. Other regulators have adopted a different approach. The implications for bank regulatory capital ratios of different regulatory approaches to the treatment of dividends are significant. Dividends are not payable to shareholders until they are declared and, as experienced during the GFC, dividends can be reduced materially from period to period and are only confirmed once they have actually been declared. To facilitate simplicity and transparency, we recommend that the Committee confirm that expected but not yet declared dividends should not be deducted from Tier 1 capital[9]. This is consistent with the focus on capital conservation being part of a bank's expected response to stressed loss outcomes.

<u>Main Recommendation 5:</u> The proposed approach to deductions should be revised to one that: recognises the value of some assets on a (stressed) going concern basis; allows both going concern and gone concern capital to share in the risk of loss; and for all deductions allows for consistency and relative simplicity.

The ABA supports the Committee's approach to harmonising capital deductions. We highlight that the changed approach will impact some banking groups more than others and recommend that the outcomes of the Committee's impact assessment be considered in the context of how the changes will impact economic activity in the short to medium term.

The deduction approach proposed in the Resilience Document does not recognise that some assets, specifically capitalised software expenses, deferred tax assets and investments in non-consolidated insurance entities, which the Committee proposes be deducted from Common Equity, will continue to have value on a going concern basis even under periods of stress (although we recognise that

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[9] To ensure symmetry of this treatment to the deduction of declared dividends, expected dividend reinvestments would not be recognised in Tier 1 capital.

these values may fluctuate). Values for capitalised software expenses and deferred tax assets will be zero on a gone concern basis. Investments in non-consolidated insurance entities will, under most circumstances, have value on a gone concern basis. In the interest of simplicity, we recommend that the Committee adopt 50/50 Tier 1/Tier 2 approach for capitalised software expenses and deferred tax assets and retain the current 50/50 Tier 1/Tier 2 approach for investments in non-consolidated insurance entities. The proposal to deduct the value of those assets from Common Equity undermines the conceptual framework for the capital structure that the Committee has proposed.

We also note that the proposals do not address the treatment of dividends in the regulatory capital framework. To facilitate simplicity and transparency, we recommend that the Committee develop an internationally consistent approach to the treatment of dividends[10].

6. Other components of the Resilience Document

6.1 Counterparty credit risk

6.1.1 Regulatory architecture for financial counterparties and transactions

The Committee proposes a number of changes to the framework for measuring and managing counterparty credit risk (CCR). The ABA supports a framework for CCR that promotes transparent and sensible measurement of inherent risk, including capital incentive structures that reflect the relative risks of different types of counterparty and transaction. We are of the view, however, that the Committee's "regulatory architecture" in relation to the framework and objectives for financial counterparties and associated transactions, is unclear. Yet, there is the potential for banks to be required to hold very large amounts of capital against over-the-counter (OTC) derivative exposures. The framework for recognising central counterparties (CCPs) is significantly underdeveloped (although we note that it appears to be further developed for some CCPs in some offshore jurisdictions, such as the US and Europe, giving rise to concerns that Australian banks will be disadvantaged).

There is therefore limited ability for banks to transact with CCPs in the short to medium term. There is also uncertainty as to which OTC derivative transactions can be cleared by a CCP as well as uncertainty in relation to the processes for accrediting and supervising CCPs.

6.1.2 Measuring CCR

The Committee is proposing to require banks to hold capital for mark-to-market losses associated with deterioration in the credit worthiness of a counterparty (i.e. Credit Valuation Adjustment Risk (CVA) risk). The Committee notes that the current Basel II framework covers the risk of counterparty default and credit migration risk but does not address CVA risk and hence is proposing a capital

[10] Work undertaken by Australian banks to understand differences in regulatory capital frameworks across jurisdictions suggests that deductions for expected but not yet declared dividends is an important driver of differences in capital outcomes and a significant source of confusion for the market.

add-on, based on use of bond equivalents, as a "proxy" for CVA risk. We note that it is unclear whether this definition of CVA is intended to align with the CVA accounting provision or whether it is intended to capture more forward looking elements of CVA.

The proposed approach in the Resilience Document is explained as a "simple" capital add-on. The ABA believes that this simple approach falls short of best practice and fails to take into account the size and complexity of the risks that are being modelled. More sophisticated modelling techniques such as Monte Carlo based methods are preferred for the purpose of deriving the effective positive exposure ("EPE") and effective maturity for each counterparty.

To the extent the Committee retains the proposed bond equivalent method; the ABA is of the view that significant recalibration of the methodology is needed. When combined, the conservative components required have the effect of increasing capital to levels significantly above the inherent counterparty risk and well above the volatility observed during the GFC. Capital requirements are conservatively scaled up by increases that are not risk sensitive and hence will not provide appropriate regulatory capital incentives for better managing CVA risk. Use of multiple layers of conservatism (i.e. multiplication of exposure-at-default - EAD - by an alpha factor of 1.4, use of the longest effective maturity, addition of a Stressed VaR, a multiplication factor of 3 and a multiplier of 5 to scale up the VaR to a 1-year liquidity horizon) produces a significantly "over-calibrated" capital requirement. In relation to the proposed use of the longest effective maturity, a preferred approach and one which more closely reflects the risks being measured is to use the weighted average maturity. Also, for banks that use the standardised market risk rules and hence were required for the QIS to use both EAD and a present value (PV) measure (multiplied by the standardised risk weights) for determining CVA, the ABA notes that EAD similarly produces capital outcomes which bear little relation to a measure of CVA risk.

The Resilience Document also proposes a narrow scope for eligible hedges that can be recognised for CVA risk measurement. These include single-name credit default swaps (CDSs), single-name contingent CDSs and other equivalent hedging instruments directly referencing the counterparty. A framework that only allows single name CDS products as hedges will only ensure a hedge is effective in the event of default. To the extent that other credit instruments, such as a credit default index, demonstrably reduce the measured VaR of the CVA bond-equivalent portfolio, such hedges should be taken into account for the purpose of measuring CVA risk. We also note that to the extent a portfolio hedge is used and some residual basis risk remains, this risk will be quantified through existing capital measures associated with internal model approaches.

The ABA is of the view that relative capital outcomes across the risk measurement methods need to allow for capital incentives to adopt more rigorous approaches to measuring counterparty risk while still ensuring that capital is commensurate with the risks of the portfolio across all approaches. This should be a consideration as part of the overall calibration. We note that the Resilience Document indicates that some of its recommendations will need to be adapted to the standardised approach to credit risk and the Current Exposure Method (CEM) for counterparty credit risk.

The Resilience Document has proposed additional requirements to stress testing and back-testing. The ABA is of the view that the framework for stress testing and back-testing be determined by national supervisors such that it is appropriate to the level of risk and complexity of the portfolio. The proposed requirements would serve as useful guidance in this respect.

6.1.3 Highly leveraged counterparties

The proposed approach to highly leveraged counterparties is similarly uncertain. For these counterparties, the Committee proposes that PD estimates for counterparties that are "highly leveraged" should reflect the performance of the counterparty's assets based on periods of stressed volatilities. It is not clear what is meant by 'highly leveraged'. The ABA notes that, while intended as a "qualitative requirement", the proposal has implications for regulatory capital and is inconsistent with the Basel Framework's requirement to use stressed loss-given-default estimates rather than PDs.

<u>Main Recommendation 6:</u> For counterparty credit risk, the Committee should clarify its "target architecture" for financial counterparties and CCR including the policy intent of the CVA capital charge. The CVA framework should allow for more sophisticated approaches to modelling CVA that better capture the complexity of these risks. The overall level of the CVA capital requirement should be recalibrated and a broader set of hedges allowed for the purpose of measuring CVA risk.

The ABA is of the view that the Resilience Document specifies the desired outcomes of the proposed changes (such as the desire to raise capital requirements) but does not provide sufficient detail in relation to the target regulatory architecture of financial counterparties and associated transactions. This includes the Committee's policy intent in relation to the components of CCR as well as the Committee's framework for CCPs, particularly, the process for accrediting and supervising CCPs and identification of those over-the-counter (OTC) derivatives transactions that can be cleared by CCPs. The ABA recommends that the Committee clarify its policy intent and target architecture in relation to the CCR and CCP frameworks. The ABA also recommends clarification from the Committee as to its definition of CVA risk. In particular, it is unclear whether the definition is intended to align with the CVA accounting provision or whether it is intended to capture more forward looking elements of CVA.

The ABA recommends that the framework for characterising CVA risk allow for use of more sophisticated approaches to CVA measurement. The ABA is of the view that the proposed bond equivalent approach is not appropriate in all instances. More sophisticated approaches are available that will better capture CVA risk. Use of more sophisticated approaches would not only improve the risk-sensitivity of regulatory capital requirements but would also allow banks to align techniques for measuring regulatory capital with those used for management of counterparty risk.

The ABA is concerned that the combined impact of the various components of the calculation would increase capital requirements to a level not commensurate with the risk, giving rise to excessive costs to OTC derivative customers. The market implications for such an outcome would be wide ranging and include a transfer of risk toward the non-regulated sector. It is unclear to the ABA if such an impact is in accordance with the overall target regime of the Committee. In the case of

measuring the maturity of the bond equivalent, the ABA recommends the use of a weighted average maturity approach which will closer align to the CVA risk profile. For institutions applying standardised market risk rules to the bond equivalents, the ABA is of the view that using the present value of the bond equivalents produces capital requirements that more appropriately reflect the CVA risks inherent in the portfolio.

The ABA recommends that the capital calculation for CVA risk allow recognition of a broader set of hedges than CDS, such as index CDS, consistent with how banks manage CVA risk. Such an approach would allow banks to use products that can be flexible enough to provide economically effective hedges against CVA risk.

<u>Supplementary Recommendation:</u> The requirement to use stressed PDs for highly leveraged institutions should be removed.

The ABA is of the view that the used of stressed PDs for highly leveraged institutions is unnecessary given that ratings assigned already reflect the risks inherent in the counterparty. To the extent the change is retained, the ABA seeks clarification as to how to interpret "highly leveraged counterparties".

<u>Supplementary Recommendation:</u> The framework should allow an appropriate transition period given the current state of development of the central counterparty framework.

The ABA recommends that the CCR framework allow a suitable transition period until such time as the CCP accreditation and recognition framework is finalised. It is difficult to recommend an appropriate minimum timeframe over which the changes to the CCP framework should be implemented given that the pathway to clearing is uncertain, particularly for regions outside the US and Europe (which will disadvantage banks operating outside of those jurisdictions).

<u>Supplementary Recommendation:</u> Overall calibration of CCR should take into account the relativities between the methods of calculation

The ABA is of the view that, as for any regulatory capital framework with a spectrum of approaches, there needs to be appropriate capital incentives for banks to use more sophisticated risk measurement methods. The ABA recommends that the Committee assess the relative capital outcomes between approaches to measuring counterparty credit risk to ensure that sufficient capital incentives are in place to migrate to more advanced risk measurement approaches (such as IMM) while still ensuring that capital is commensurate with the risks of the portfolio across all approaches. The ABA recommends appropriate industry consultation prior to finalising recalibration of the standardised approach to credit risk or the CEM for counterparty credit risk.

<u>Supplementary Recommendation:</u> Stress testing and back-testing requirements should be set by national supervisors.

The ABA recommends that stress testing and back testing requirements be set by national supervisors drawing on guidelines set out by the Committee. Such an approach would ensure that requirements are appropriate to the sophistication of each jurisdiction's and/or bank's product set and level of risk and that an appropriate balance between adequate risk control and cost is achieved. The ABA recommends that the proposed requirements be provided as guidance to national supervisors.

6.2 Securitisation

The Resilience Document notes that the Committee is undertaking a more fundamental review of the securitisation framework, which may lead to a recalibration of required capital. As a general observation, the ABA notes the frequency of changes to the securitisation framework. Some regulators have indicated that banks need to ensure that securitisations are sufficiently flexible to comply with changes to regulatory requirements over time. The ABA believes that it is unrealistic for a bank to structure a securitisation to comply with future unknown changes. Such a regulatory environment will lead to significant uncertainty for banks and investors, providing disincentives to entering and/or investing in the market. From a rating agency perspective there are limits on the extent that flexibility to comply with future changes to regulatory requirements can be incorporated into a securitisation. To counter such impacts, the Committee should require that national supervisors grandfather existing securitisations so as to prevent the potential selling of exposures at a material loss and the impairing of capital bases.

The ABA seeks clarity in relation to the scope of resecuritisation exposures. We note that some additional guidance has been provided in the recent *Frequently asked questions on the comprehensive quantitative impact study, 9 April 2010* (QIS FAQ) although we do acknowledge that the QIS FAQ itself states that "answers provided are not to be construed as an official interpretation of the documents". Specifically, many securitisation programmes regularly have investment mandates allowing for surplus cash collections (a small component of the overall structure) to be invested in a mortgage-backed securities (MBS) or asset-backed commercial paper programmes (ABCP). The QIS FAQ indicates that if the programme allows surplus cash to be invested in MBS or ABCP, it would trigger the structure to be classified as resecuritisation. This "cliff approach" does not reflect the differing risk profiles of surplus cash invested in MBS or ABCP relative to much more risky structures (such as a CDO squared comprising all resecuritisation exposures).

<u>Supplementary Recommendation:</u> Existing securitisation exposures should be grandfathered.

The ABA recommends that to the extent changes are made to the securitisation framework, transactions issued prior to the finalisation of the changes be grandfathered to the existing rules.

<u>Supplementary Recommendation:</u> A more risk sensitive framework for resecuritisation should be introduced.

The ABA recommends that, as part of the review of the securitisation framework, a materiality threshold be introduced that reflects the degree of risk in the transaction. This would recognise the differing risk profile between a portfolio with a low resecuritisation exposure and a portfolio with a high resecuritisation exposure. In the absence of a specific materiality threshold, the rules should allow national supervisors discretion to permit exemptions up to a nominated threshold amount.

6.3 Systemically important banks

The ABA does not support proposals that systemically important banks should be subject to higher levels of regulatory capital than banks that are not deemed to be systemically significant. In support of its views, the ABA makes the following two observations.

- The GFC demonstrated that circumstances determine which banks are systemically significant rather than a predetermined set of rules. A bank that is not regarded as systemically significant in a period of strong economic growth may in fact become systemically significant during a period of stress.
- Requiring banks with the same risk profile to hold different levels of regulatory capital will lead to market distortions, especially given the existence of deposit insurance.

Supplementary Recommendation: Systemically important banks should not be subject to disproportionately higher levels of regulatory capital.

The ABA is of the view that systemically important banks should not be subject to disproportionately higher levels of regulatory capital under Pillar 1. A higher level of supervision is appropriate under the current Pillar 2 framework.

7. Disclosure

The ABA agrees with the Committee's sentiments regarding the value of public disclosure in improving the transparency of regulatory capital and improving market discipline. Consistent with Recommendation 2, we are of the view that, to the extent that capital and liquidity frameworks in local jurisdictions differ from the international norm, these differences should be required to be clearly identified in local prudential frameworks and public disclosures in order to facilitate comparisons by the market.

While we agree in principle with the Committee's proposed requirements in relation to disclosure, one aspect where we do have concerns is disclosure of the "full" terms and conditions of a private placement of Tier 1 capital. While the main features of these instruments should be publicly disclosed, making the detailed terms of these instruments publicly available is unnecessary. We believe that market disclosure of such issues should be limited to material, general and essential terms (e.g. call rights or features that impact on permanency), and not to full details of the placement. To require otherwise would limit bank access to a potentially important source of capital and weaken the pricing/negotiation of banks with institutional investors without serving any useful prudential purpose.

One aspect not detailed in the proposals is the *frequency* of required disclosures. Notwithstanding the comments made above, the ABA seeks to limit any additional disclosures on a quarterly basis. In saying this, the ABA acknowledges the focus of the Australian market on semi-annual financial statement disclosures and highlights that banks listed on the Australian Stock Exchange (ASX) must meet the continuous disclosure requirements of the ASX in relation to information that may have a material effect on the share price. We note that recent experience in the US and Europe suggests that an increase in quarterly market disclosure does not assist in a more transparent and better operated financial system and,

instead, has the potential to create "short-termism", noise and an unfounded increase in volatility.

<u>Supplementary Recommendation:</u> Full disclosure of capital instrument terms should be limited to public issues, and such disclosures should be made semi-annually.

The ABA is concerned that information relating to the terms of private placement is commercially sensitive. We therefore recommend that disclosure for these instruments be limited to material, general, essential terms (e.g. call rights or features that impact on permanency) and not to full details of the placement. The ABA also recommends that disclosure in relation to capital instruments and other items are limited to a frequency of semi-annually to minimise "short-termism", noise and an unfounded increase in volatility.

8. Macroeconomic implications

The ABA is concerned that "over-calibration" of the capital changes, when combined with the changes to liquidity, will give rise to a significant slowdown in the availability of credit, and an increase in its cost, thereby presenting an impediment to economic recovery and longer-term growth. The main channels through which the impact will be transmitted are funding constraints, which will impede banks' ability to lend, and the cost of lending, which will increase in response to the need to recover the higher costs associated with the increased requirements.

The ABA acknowledges that there is significant regulatory activity under way currently to assess the "bottom up" implications of the regulatory changes. In particular, the QIS appropriately commissioned by the Committee will likely reveal a very large gap between the current state of the industry and the world envisaged by the proposed framework. It is not clear, however, that the QIS will highlight the significant second round impacts that the proposals will have on lending activity.

We understand that the Committee is undertaking other activity to assess the "top-down" implications of the revised framework. Top down analysis should include consideration of funding costs, profitability, rating agency and market demands, funding and capital constraints, bank lending and economic growth. It should also consider the potential for financial market distortions and/or dislocations in response to the proposed rules.

Estimating the potential impact is complicated by assumptions about the Committee's possible calibration, as well as by the linkages that exist between the various components of the framework. In terms of the latter, the linkages between components, such as between the minimum capital requirement and the proposed capital buffers or between the definition of capital and forward-looking provisioning, are particularly complex. Compounding this complexity is the Committee's objective of aligning accounting and regulatory approaches to provisioning.

Unfortunately, there are no readily available numerical or statistical models to guide assessment of the abovementioned variables and to assist in calibrating the outcomes. The complexity of required modelling, coupled with the uncertainty in relation to calibration, is such that the ABA is yet to complete a detailed

assessment of the overall impact. The main channel through which the impact will be transmitted is interest rates. Banks will respond to the changes by raising spreads between deposit and lending rates owing to the need to recover the higher costs associated with increased liquidity and capital requirements. It is, in part, the repricing of deposit and lending rates that will impact the community. The extent to which the impact of the changes falls on the quantity of lending rather than on the price of lending depends on the demand elasticity for bank lending and the supply elasticity of non-bank lending.

We encourage the Committee to work with industry to develop a comprehensive cost/benefit analysis so that the outcomes of the proposals are understood and fully worked through. The outcomes of the analysis should be publicly disclosed to assist in managing community expectations as to the impact of the proposals. Clearly, there is still much work to be undertaken in order that the regulatory community and banking industry be fully apprised of the implications of the changes proposed in the Consultative Documents. These changes could have detrimental consequences for economic growth depending on the final calibration and the period over which the changes are phased in.

Attachment

Components of capital - other items

The ABA makes the following additional comments in relation the definition of capital

- The Document proposes that all of a bank's investments in its own common shares be deducted from the Common Equity component of Tier 1 (unless already 'derecognised' under the relevant accounting standards), together with any own stock which the bank could be contractually obliged to purchase irrespective of whether the investments are in the banking or trading books. The ABA seeks confirmation that this requirement will not apply to own shares held but not beneficially owned, such as those held by employee share trusts on behalf of employees or those held in bank-owned life insurance companies that are not consolidated for regulatory capital purposes.

- The Document proposes that deferred tax assets which rely on the future profitability of the bank to be realised and deducted from the Common Equity component of Tier 1. Our response to deducting this from Common Equity has been discussed in the main body of this submission. Notwithstanding this, the amount of such assets deducted should be net of deferred tax liabilities. We recommend that, consistent with current Australian regulatory requirements, netting between deferred tax assets and liabilities only be permitted where a bank has a legally enforceable right to set-off current tax assets against current tax liabilities. This would require that the assets and liabilities relate to income taxes levied by the same taxation authority and the taxation authority permits the bank or banking group entities to make or receive a single net payment.

- The Resilience Document suggests that banks' Available for Sale (AFS) Reserves for unrealised gains and losses on balance sheet items will be able to be included in the Common Equity component of Tier 1 capital under the revised regulatory capital framework. We note the Committee's comments that it will continue to review the appropriate treatment of unrealised gains. The ABA is of the view that inclusion of the AFS reserve in Tier 1 capital will increase the volatility of Tier 1 capital to unacceptable levels, which is contrary to the Committee's objective of reducing procyclicality. We therefore propose that the AFS reserve be excluded from Tier 1 capital. This will also ensure alignment with the proposal to exclude Cash Flow Hedge Reserves. We recommend that this approach be reviewed once additional clarity is obtained on the changes to International Financial Reporting Standard 9 Financial Instruments: Classification and Measurement (IFRS 9). The current exposure draft for IFRS 9 proposes that AFS Reserves be eliminated and any balances transferred to retained earnings.