MEMORANDUM FOR	FSO Committee
FROM	Financial Policy (Principal author: Paula Hontalba)
MEETING DATE	27 September 2018
SUBJECT	Capital Disclosure
FOR YOUR	Information

We recommend that FSO:

1) **Note** that as part of the Capital Review, we have been monitoring APRA's proposed changes to the capital framework for Australian Deposit-taking Institutions (ADIs) and assessing the merits of increased alignment with APRA;

2) **Note** that APRA's recently published discussion paper*, Improving the transparency, comparability and flexibility of the ADI capital framework,* consults on different ways to present the relative capital adequacy position of ADIs, by requiring ADIs to disclose some form of *'internationally harmonised'* capital ratios, although APRA noted that status quo remains to be an option; and

3) **Note** that APRA intends to respond to submissions for their recent proposal in early 2019, and that Financial Policy will conduct more thorough assessment once APRA has made a decision on which option it will adopt.

Background

1. The aim of the Capital Review is to identify the most appropriate capital framework for New Zealand. The most relevant Capital Review principles for this paper are:
    a. Capital requirements of New Zealand banks should be conservative relative to those of international peers, reflecting the risks inherent in the New Zealand financial system (country-risk) and the Reserve Bank's regulatory approach (focus on disclosure requirements and market discipline rather than supervisory overlays).
    b. The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs, and take into consideration relationships with foreign-owned banks' home country regulators.
    c. The capital framework should be transparent to enable effective market discipline.

2. In line with the principles above, particularly 1b, we have been monitoring APRA's proposed changes to the capital framework for Australian Deposit-taking Institutions (ADIs). As part of the Capital Review, we are considering the merits of increased alignment with APRA's capital framework.

APRA's proposal

3. In August 2018, APRA published its proposal to "improve the transparency, comparability and flexibility of ADI capital framework".[1] APRA's proposal focuses on the presentation of capital ratios and is not intended to change the quantum of capital requirements. This proposal also seeks to address the 2014 Australian Financial System Inquiry's (FSI) recommendation that APRA set capital standards such that Australian ADIs' capital ratios are *'unquestionably strong'*, with a target of being in the top quartile (25%) of internationally-active banks.

4. Similar to our current approach, APRA has historically increased minimum capital requirements through targeted measures that strengthen the definition of capital (numerator) and the determination of risk-weighted assets (RWAs). Some of APRA's adjustments recognise underlying country-risk that would not be adequately captured in a pure implementation of the Basel framework (e.g. the Basel calibration for commercial property exposures is viewed as insufficient given Australia's loss experience), whereas others reflect APRA's desired level of regulatory conservatism/risk appetite (e.g. deductions for Deferred Tax Assets and other equity investments). In a 2015 *International Comparison Study*, APRA claimed that compared to Australia, most jurisdictions have fewer areas with stricter requirements than the Basel framework for RWAs, noting that most jurisdictions increase capital requirements by imposing higher minimum capital ratio.[2]

5. Following this study, the Big 4 ADIs began reporting *'internationally harmonised'* ratios, claiming that they followed APRA methodology. APRA's consultation paper noted that self-selection of disclosed items and self-reporting of capital ratios could impede market credibility in these 'internationally comparable' ratios.

6. APRA has identified two main drawbacks with the approach of applying conservatism through adjustments for RWAs and definition of capital, rather than increasing minimum overall capital ratio requirements:

    a. **Lower reported capital ratios** – As a result of APRA's adjustments, APRA claims that the reported capital ratios of ADIs are lower compared to international peers.[3] APRA is concerned that this may make it more difficult or more costly for ADIs to access international capital markets if Australian capital rules are not well understood by international investors, particularly in times of funding market stress.

    b. **Lack of flexibility in dealing with stress situations** – APRA noted that the more conservatively calculated capital ratios of ADIs are closer to the Basel minimum ratios and 'triggers' (e.g. the 'non-viability' trigger) than those of banks in other jurisdictions. In other words, all else equal, an Australian bank

---

[1] https://www.apra.gov.au/improving-transparency-comparability-and-flexibility-adi-capital-framework

[2] https://www.apra.gov.au/media-centre/media-releases/apra-releases-international-capital-comparison-study

[3] APRA estimates that as at June 2017, the average internationally comparable CET1 capital ratio of the Big 4 ADIs is 485 basis points (4.85%) higher than the average reported CET1 capital ratio.

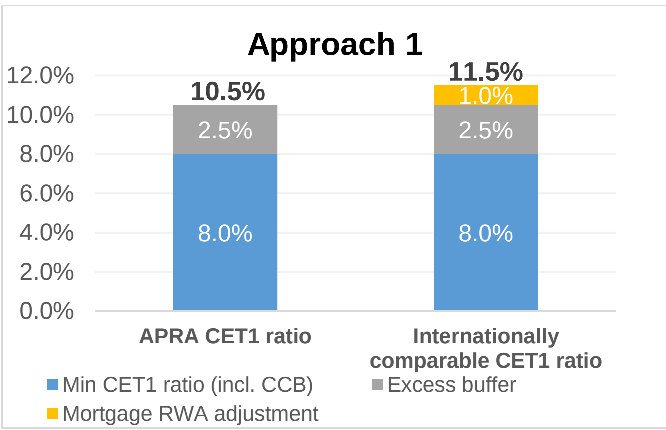
will be deemed 'non-viable' earlier than would be the case if it was regulated in another jurisdiction.[4]

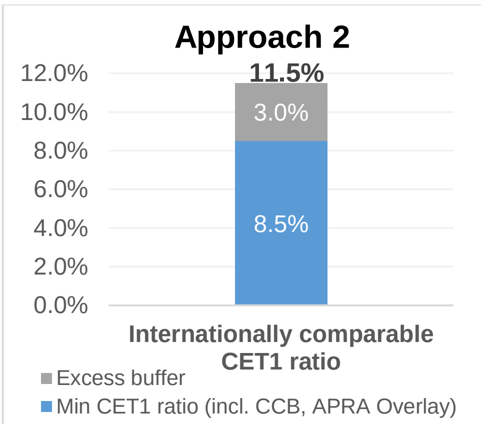
7. To address the aforementioned potential drawbacks, APRA is consulting on two potential approaches to enhance transparency:

   a. **Approach 1: Consistent disclosures** – APRA would endorse two capital ratios: i.) an APRA regulatory capital ratio to be compared against minimum requirements, and ii.) an *'internationally harmonised'* disclosure-only capital ratio using an APRA-prescribed methodology that unwinds certain aspects of relative conservatism in its capital framework.[5] The major ADIs already calculate and disclose such *'internationally harmonised'* ratios on their own initiative, guided by APRA's 2015 comparative study (discussed below). However, the argument is that the current disclosures may lack credibility without APRA's validation and endorsement of them.

   b. **Approach 2: Capital ratio adjustments** – APRA would modify the calculation of regulatory capital ratios to use the *'internationally harmonised'* definitions of capital and RWA, which would result in higher reported capital ratios. To maintain the desired quantum of capital, APRA would subsequently increase minimum capital ratio requirements for each ADI, proportionate to the impact of APRA's aspects of relative conservatism on the ADI that have been unwound. This approach requires periodic recalculation (e.g. annually) of the ADI-specific capital requirements.

8. A stylised example of the two approaches is presented below. In this example, unwinding the higher risk weights for mortgages results in 1% higher comparable CET1 ratio under Approach 1. Under Approach 2, APRA increases a combination of the minimum and buffer ratios by 1% to compensate for the lower risk weights, producing the same quantum of total required capital as in Approach 1.





---

[4] If a banking group's CET1 ratio falls below 5.125%, then the AT1 debt instruments will be converted or written off. As a result of APRA's applied conservatism, an ADI with a CET1 capital ratio of 5.125% in Australia will have higher absolute level of capital held compared to if that bank had a 5.125% CET1 ratio under another jurisdiction's implementation of the Basel framework.

[5] Some aspects of relative conservatism that APRA identified are: capital deduction for investments in financial institutions, higher correlation factors for residential mortgages and commercial property exposures, and higher LGD estimates for some exposures (including mortgages).

9. Aside from the two approaches, APRA is also consulting on the option to maintain *status quo* (i.e. keep tighter definitions of capital and RWA adjustments), and also on the option to pick and choose certain elements of Approach 1, 2, and *status quo*. APRA has expressed their preference for a combination of the different approaches, although they have not provided specific details on how this might work.

10. APRA notes that the benefits of enhanced transparency need to be weighed against increased operational complexity. In particular, the approaches that APRA are considering will have significantly smaller impact (i.e. uplift) on the capital ratios of standardised banks compared to IRB banks. OIA s9(2)(ba)(ii) [redacted].

Challenges with assessing relative capital adequacy

11. To estimate the *'internationally harmonised'* ratios under either approaches, APRA draws from its 2015 International Capital Comparison study. In this study, APRA acknowledged that due to additional measures adopted by different jurisdictions that are more conservative than the Basel minimum standards, *"computing a precise 'internationally harmonised' capital ratio is not practically possible".*

12. Aside from making several assumptions, APRA also did not make certain adjustments that could have negatively impacted the relative position of the Australian major banks (Big 4), due to limitations on publicly available data. These adjustments are:

    a. **Exclusion of potential impact of capital floor –** At the time that APRA conducted their study, all Basel member jurisdictions, except for Australia, were still implementing a capital floor in some form, based either on Basel I or Basel II standardised approach. Furthermore, Basel III reforms impose a floor on the minimum capital requirements of IRB-accredited banks (i.e. IRB have to hold the higher of minimum capital requirements generated by 1. internal models approach or 2. at least 72.5% of standardised approach). APRA did not assess whether a form of capital floor could be binding and could affect the minimum capital requirements of foreign banks. APRA acknowledged that failure to do this adjustment could have a material unfavourable impact on the relative standing of the Big 4.

    b. **No adjustments to foreign banks' RWAs** - APRA relied on Basel 6-monthly reports, which collect anonymised data on large and internationally active banks from member jurisdictions.[6] APRA claims that compared to Australia, most jurisdictions have fewer areas with stricter requirements than the Basel framework for RWAs. It's possible that if APRA adjusted for jurisdiction-specific RWA measures, the *'internationally harmonised'* capital

[6] https://www.bis.org/bcbs/qis/

ratios of foreign banks would increase (and relative ranking of Big 4 banks would decrease).

13. APRA also noted that it is challenging to determine which jurisdictional differences in RWAs should be unwound for capital comparison purposes. Similar to our view that regulator constraints that aim to capture systemic risks should not be unwound to arrive at *'internationally harmonised'* ratios, APRA concluded that *"it is not appropriate to adjust for differences in risk profile, since comparable capital adequacy ratios should account for differences in risk."*[7]

14. It is important to note that APRA's recent proposal implicitly assumes that the Basel minimum framework represents the average international capital adequacy framework. However, in adopting Basel III reforms, other jurisdictions may choose to adopt more conservative requirements, to account for differences in country risk profile.

Implications for the Capital Review and next steps

15. We note that it is important that international investors understand NZ's regulations and specific capital requirements, given the Big 4 banks' considerable reliance on offshore funding. Moreover, we note that APRA's proposal may benefit NZ banks, if the disclosure of *'internationally harmonised'* capital ratios leads investors to assess the capital adequacy and soundness of the four Australian parent banks more favourably. However, we are of the view that there are other more reliable measures that investors can use to compare international banks, such as credit ratings, S&P's Risk-Adjusted Capital Ratio, the leverage ratio, and dual reporting, given the considerable uncertainty involved in estimating *'internationally harmonised'* ratios.

16. We are of the view that dual reporting would enable better comparisons of banks operating in foreign jurisdictions. As a result of Basel III's output floor proposal, banks in Basel member jurisdictions will likely be required to disclose RWA on both IRB and standardised bases. Nonetheless, we will keep a 'watching brief' over developments in the ADI capital framework, and provide more thorough assessment once APRA has decided on a particular option.

[7] See Guthrie (2018) #7501602