MEMORANDUM FOR FSO Committee

FROM Financial Policy (Author: Charles Lilly)

MEETING DATE 18 May 2016

SUBJECT **Capital Review: components and timelines**

FOR YOUR Information

It is recommended that the Committee:

1. **Note** that Financial Policy will be undertaking a review of bank capital requirements over 2016-17.

2. **Note** that this paper provides a timeline and overview of the papers that we intend to present to the Committee over the coming months.

1. The purpose of this paper is to provide the Committee with an overview and timeline of Financial Policy's review of bank capital requirements.

Background

2. FSO decided not to adopt a higher loss absorbency capital requirement for D-SIFIs in early 2014.[1] Instead, it was decided that it would be more appropriate to carry out a more general review of the capital adequacy requirements and their calibrations for all banks and NBDTs.

3. In light of the D-SIFI decision, a subsequent paper assessed the capital implications of the Basel II internal models approach used by the four large banks in a paper to FSO in April 2015.[2] The paper's main finding was that the modelled approaches had contributed to an overall lowering of banks' capital requirements that was unlikely to be fully justified by the better risk management the modelled approaches are said to facilitate. FSO agreed for Financial Policy to carry out further work exploring a number of issues in the capital adequacy framework, including the option of floors for modelled outcomes tied to the standardised requirements, changes to the calibrations of different portfolios, and prohibiting the modelling of 'unmodellable' portfolios.

4. At the same time as we have been progressing our internal thinking on these issues, the Basel Committee has released a number of consultation papers on changes it intends to make to the global capital adequacy framework over 2017/18. Many of the changes (such as removing modelling for some portfolios) overlap with the issues we seek to investigate as part of our capital review. Gael Price presented a summary of the upcoming changes to the Basel framework to the Committee in April.[3]

[1] FSO minutes #5629829
[2] #5809096
[3] #6493041

Problem identification

5. Notwithstanding the gradual increases in our emphasis on regulatory discipline in recent years, it would be reasonable to say that our approach to prudential supervision remains at the 'low intensity' end of the spectrum of international regulators. We have historically taken a conservative approach to setting capital requirements in concert with this supervisory philosophy.

6. In recent years capital requirements under other regulatory regimes have been ratcheted up, for example through SIFI buffers and more extensive Pillar 2 requirements. Adopting these measures could weaken the internal consistency of our supervisory philosophy and may be at odds with our current level of resourcing (for example in quantifying appropriate bank-specific Pillar 2 add-ons). However in their absence we consider it appropriate to question whether our regime today is really as conservative as we believe it to be.

7. The overarching question we seek to address is:

   Given the Reserve Bank's philosophical approach to banking supervision, is the current quantum and quality of capital appropriate to achieve our objectives?

Work programme and timeline

8. In practice, our capital review will be a series of papers to the Committee that touch on different aspects of the capital adequacy framework. A description of each paper and indicative timeline is as follows:

Supervisory philosophy [by PSD managers]	June
PSD managers will provide the Committee with an overview of the Bank's supervisory approach, the trade-offs and challenges involved, and options for the supervisory philosophy the Bank wishes to operate.	
The status quo	July
The paper will include a narrative of how the Bank arrived at its current capital framework, including the decision to adopt internal modelled approaches and the Basel framework more generally. The paper will compare the Bank's current capital requirements with those set by APRA, in order to establish (in a relative sense) how conservative our current framework is. This work will make use of APRA's "International Capital Comparison Study" that established (quantitatively) the relative capital strength of Australia's large banks under a 'vanilla' implementation of the Basel framework. The paper will also provide an assessment of the extent to which our current capital adequacy framework departs from the Basel framework.	
Literature review on optimal capital levels	July
The paper will examine recent academic studies into the costs and benefits of different levels of capital requirements. For example, it will present views on the applicability of the Modigliani and Miller theorem to banks (i.e. is capital costly?) as well as recent empirical estimates of what an 'optimal' capital ratio might be.	
Macroeconomic effects of different capital settings	July
The paper will revisit the model that the Bank used to estimate the effects of higher capital requirements when Basel III was implemented in 2013. The focus of the modelling exercise is to estimate the macroeconomic effects of marginal changes to capital requirements given current settings (i.e. taking into account the work described above on our starting point), as opposed to trying to estimate an optimal capital ratio from a clean slate.	

Internally modelled approaches	August - October
We will expand on Cavan O'Connor-Close's FSO paper from 2015 that identified several issues with the application of the internally modelled approaches to capital adequacy. The work will draw on our eight years of experience in operating an internal models regime. We will revisit the question of whether to allow modelled approaches, and if so, to which types of portfolios. We will cover which types of controls could be put in place to reduce any unjustifiable variations in capital outcomes (between models banks, and when compared to standardised outcomes) and the opacity of modelled approaches. For instance, options may involve the greater use of floors on model outputs, greater disclosure of models and their outputs, and parallel calculation and disclosure of modelled and standardised outcomes. A number of these options feature in recent Basel Committee consultation documents. We will also address issues related to the calibration of models, such as the use of stress testing as a calibration method. By this stage we hope to have the tentative results of the Benchmarking exercise for banks' residential mortgage and rural portfolios, which will inform the discussion of calibration. Given the broad range of issues involved, this work will likely be split over multiple papers to the Committee.	
Standardised approaches	September
The paper will provide a summary of the upcoming changes to the Basel framework, which (in general) aim to improve risk differentiation in the standardised approach and allow for better comparability between the standardised and modelled approaches. The paper will also assess the calibration of the standardised approach by, for instance, making use of internal models banks' parallel calculation of standardised and modelled outcomes that we will receive as part of the Balance Sheet project.	
Composition of capital	October
These papers will discuss the role and merits of the different tiers of capital (CET1, AT1, Tier 2) in our capital framework. This will include a discussion of total loss absorbing capacity (TLAC) requirements, and the levels of the different ratios (including, for example, cross-country comparisons of the use of different tiers).	
Basel Committee consultations	2016/2017
Taking into account the outcomes of the work programme above, we will present the Committee with options on if and how to adopt the changes to the Basel framework as these are finalised over the next two years.	

9. In parallel with the capital review, PSD is undertaking a restructure of the Banking Supervision Handbook. The restructure is one of the outcomes of the Regulatory Stocktake, to make our requirements clearer and more consistent. The timing of the capital review has a bearing on the scope of the Handbook restructure, as there may be large changes to the content of the capital adequacy chapters. We had previously identified the credit risk sections of BS2A/B as a priority for the handbook restructure. We continue to hold the view that these areas are a priority, but seek to ensure that the capital review and handbook restructure processes are run in parallel such that resources are used optimally. Our intention is to use an external contractor to undertake the drafting of the new capital chapters and to undertake the restructure of the capital chapters in a two staged approach that takes account of potential content changes. Stage one would be to establish the 'framework' of the capital adequacy chapters of the new Handbook, including creating an overview document, commencing work on the glossary and establishing the structure of the document. Stage one would be undertaken on a 'no change in content basis'. Under stage two we would populate the new chapters with the outcomes of the capital review, which will emerge as the changes to the Basel framework become clearer.

10. Throughout the capital review we will need to communicate with banks, the Treasury, the Minister, APRA, and other stakeholders, although formal consultations on framework changes are likely to be some time away. Our current

thinking is that the Communications Committee could promote a speech in July or August, outlining the status of the capital review, our thinking and the expected direction of travel. This could be a good time to release some of the initial work (such as the literature review or modelling) alongside a high-level discussion paper.