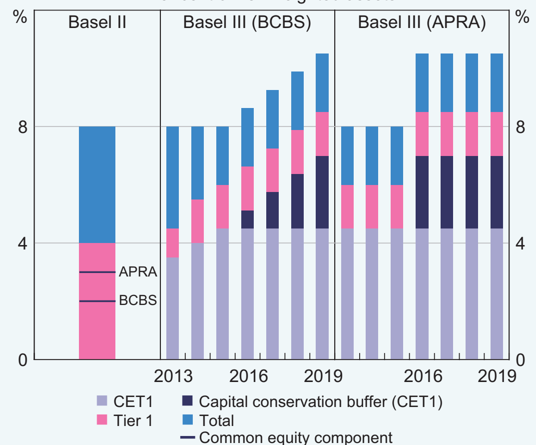
Box B
The Basel III Capital Reforms in Australia

A bank's capital represents its ability to absorb losses. To promote the resilience of banking systems, regulators specify the minimum amount of capital that banks should hold, as well as the form it should take. The 2008–09 financial crisis revealed that banks in some countries were not holding enough loss-absorbing capital for the risks they were taking. In response, the international bank standard-setting body, the Basel Committee on Banking Supervision (BCBS), developed the Basel III capital framework, which it finalised in June 2011.[1] The new framework sets out internationally agreed minimum requirements for higher and better-quality capital for banks globally, as well as better risk coverage and a new non-risk-weighted 'leverage ratio'. Complementing these reforms are enhanced public disclosure requirements for banks' capital.

The Basel III capital reforms significantly build on the Basel II risk-sensitive capital framework in a number of ways.

- The minimum Tier 1 capital requirement has been increased, from 4 per cent to 6 per cent of risk-weighted assets (RWAs) once fully phased in (Graph B1). A new common equity Tier 1 (CET1) requirement has been introduced, which raises the proportion of common equity – the highest-quality form of capital – within the Tier 1 requirement.
- The definition of non-common equity capital – that is, 'additional Tier 1' capital and Tier 2 capital – has been revised, given that some instruments previously classified as regulatory capital were not available to absorb losses as they occurred during the financial crisis. In particular, non-common equity capital instruments must now contain a non-viability trigger (and in some cases a loss absorption trigger) for conversion to CET1 or write-off.
- A stricter approach to deductions from regulatory capital has been adopted, including that most deductions are to be made from common equity capital.
- To improve risk coverage, counterparty credit risk on over-the-counter derivatives now attracts an additional capital charge, while credit exposures to central counterparties are subject to a new capital charge.[2]



* All dates are as of 1 January; minimum regulatory capital requirements are not directly comparable due to differences in definitions and differences in phase-in arrangements for Basel III

Sources: APRA; BCBS

1 See BCBS (2011), 'Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems', (revised version) June.

2 Capital requirements for certain trading book and securitisation assets were increased at the start of 2012; this change is commonly referred to as Basel 2.5.

The Basel III capital reforms also include some new elements, most of which do not start to be phased in until 2016.

- A 'capital conservation buffer' of 2½ per cent of RWAs will provide banks with additional capital that they can draw upon in stressed periods. This buffer is entirely in the form of CET1. As such, the minimum CET1 capital requirement plus the buffer will be 7 per cent of RWAs, once both are fully phased in. If a bank's CET1 ratio falls below 7 per cent, constraints on its capital distributions will be imposed (as well as other supervisory measures).
- A 'countercyclical capital buffer' of up to 2½ per cent of RWAs (entirely in the form of CET1) may be imposed by the relevant national authority during periods when system-wide risk is building up.
- A 'leverage ratio' will be included as a supplementary measure, to ensure that banks do not become overly leveraged on a non-risk-weighted basis.

The public disclosure regime for banks has also been revised, with requirements for additional information on capital adequacy, full details of individual regulatory capital instruments and a reconciliation of regulatory capital with the reported financial accounts. A comprehensive explanation of how a bank calculates its regulatory capital ratios is also required. One of the objectives of the enhanced disclosure requirements is to facilitate more consistent measurement of banks' capital adequacy, including across countries.

Implementation of Basel III Capital Reforms in Australia

The Australian Prudential Regulation Authority's (APRA's) application of the Basel III capital framework started to come into effect in Australia on 1 January 2013. These reforms leave the Australian banking system better placed to cope with future adverse shocks, and therefore should support the economy over the long term.[3]

In implementing the Basel III capital framework, APRA determined that Australian authorised deposit-taking institutions (ADIs) did not need the extended transition made available to national supervisors by the BCBS, with the exception of transitional arrangements on pre-existing non-common equity capital instruments. Indeed, Australia's banks exceed the 2013 minimum capital requirements, and similarly are on track to meet the 2016 minimum requirements. Part of the reason for this is that APRA historically adopted a somewhat more conservative approach to its capital standards than the previous Basel II international minimum, both in terms of its common equity requirement and its treatment of deductions. Moreover, Australian banks were able to raise private capital during the 2008–09 crisis, and their robust profitability over subsequent years enabled them to strengthen their capital positions further.

In regard to the specific timing, APRA required ADIs to meet its new capital requirements for CET1 capital and Tier 1 capital at the start of this year (two years ahead of the BCBS' phase-in deadline); they must also meet the full capital conservation buffer requirement at the start of 2016 (three years ahead of the BCBS' phase-in deadline) (Graph B1). Like Australia, a number of other countries, including Canada and Singapore, have decided to implement certain aspects of the Basel III international capital requirements ahead of the BCBS' time lines.

APRA also did not adopt the Basel III concessional treatment for certain capital items, most notably the 'threshold treatment' for deduction of investments in other financial institutions, mortgage servicing rights and deferred tax assets. Under this concession,

3 For a discussion of the economic benefits and costs of higher capital requirements under Basel III, see APRA (2012), 'The impact of the Basel III Capital Reforms in Australia', *APRA Insight*, Issue 2, pp 32–59.

deduction of these items from capital may be avoided if their value falls below a certain threshold.[4] APRA's treatment of these items reflects its longstanding policy of requiring their full deduction. Estimates published recently by the Australian major banks suggest that these adjustments would have the effect of increasing their CET1 capital positions by roughly 1 to 1½ percentage points of RWAs, if they were calculated according to the BCBS Basel III minimum requirements. The approach of being more conservative than the internationally agreed capital framework is not uncommon, with many countries increasingly doing so because of their domestic circumstances.

More generally, the BCBS is committed to reviewing its members' domestic regulations to ascertain their consistency with the Basel international capital framework. Australia is currently undergoing such a review, which is to be completed early next year.

4 Under the BCBS rules, significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities), mortgage servicing rights and deferred tax assets arising from temporary differences, must be deducted from capital if they exceed 15 per cent of CET1 after the application of all deductions. In addition, a 10 per cent limit is applied to each item.