INFORMATION PAPER

An Unquestionably Strong Framework for Bank Capital

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Executive summary

Capital is the cornerstone of financial safety and system stability. Over the past four years, APRA has been consulting with industry on the design of a new regulatory capital framework for Australian banks, locking in an unquestionably strong level of capital in the system and ensuring it is well-equipped to respond to any future shocks.

This information paper, *An Unquestionably Strong Framework for Bank Capital*, provides an overview of the new capital framework, which will come into effect from 1 January 2023. It outlines the objectives of the framework and its key features, and is intended to help Boards, senior management, investors and other market participants understand the new regulatory standards that will apply.[1]

An Unquestionably Strong framework

APRA's primary objective in reforming the bank capital framework has been to strengthen the resilience of the Australian financial system; to ensure that the banking industry maintains an unquestionably strong level of capital in normal times and has the in-built flexibility to weather adverse conditions, as well as to update Australian standards to align with the internationally agreed Basel framework.

Since the global financial crisis, Australian banks have increased Common Equity Tier 1 Capital (CET1), the highest quality of capital, from around $130 billion to over $260 billion, more than doubling in a decade. APRA's new standards are designed to underpin and reinforce this capital strength, while at the same time positioning over half of that amount of capital as buffers that are available to be used if needed in stress.

An unquestionably strong banking industry is central to the stability of the financial system: protecting depositors during periods of stress, ensuring banks can access international funding during good times and bad, facilitating payments, supporting lending to households and businesses when they need it, and reducing both the probability and the impact of financial crises.

Enhancing flexibility and other key improvements

In the design of the new framework, APRA has sought to enhance flexibility through higher capital buffers, and achieve a number of other objectives: improving risk sensitivity, competition, transparency and proportionality. These objectives are embedded in the fabric of the framework, through variances in the level of capital required to be held for different types of loan and different types of bank. At times these objectives have reinforced each other, and at times they have required trade-offs to be made.

[1] Alongside this information paper, APRA has separately released a response to submissions paper, *Finalising the Bank Capital Reforms* (November 2021), which sets out a response to feedback received in the final consultation and details key changes in the final specifications of the standards.

The framework is designed to:

- **increase flexibility**, through larger capital buffers that can be used by banks to support lending during periods of stress;
- **enhance risk sensitivity**, including through a reduction in capital requirements for lower risk residential mortgages and small business lending, and an increase for higher risk mortgages;
- **support competition**, building in safeguards to ensure that capital requirements for advanced banks that use internal models do not become excessively low, relative to standardised banks that use APRA-prescribed risk weights;
- **improve transparency**, by increasing the alignment of APRA's standards with the international Basel framework, and making it easier to compare capital strength across advanced and standardised banks through better disclosures; and
- **increase proportionality**, through the introduction of simplified capital requirements for smaller, less complex banks relative to larger, significant financial institutions (SFIs).

Further detail on the new capital framework is outlined in the following chapters. Chapter 1 provides an overview of the framework, as well as APRA's expectations for capital management and the use of buffers. Chapter 2 provides a summary of how capital has been allocated to different types of loan, and the enhanced risk sensitivity of the framework. Chapter 3 outlines the steps that have been taken to support competition, and Chapter 4 concludes with a summary of the approach to transparency and proportionality.

Bank capital: 2023 and beyond

The updated prudential standards for capital adequacy and credit risk capital, published alongside this information paper, will come into effect from 1 January 2023.[2] Over the year ahead, APRA will finalise guidance to assist banks in complying with the standards, and progress revisions to associated reporting requirements and other related standards.[3]

APRA expects that all banks will ensure that they are ready to meet the minimum standards when they commence, and seek to implement better practice in capital management in line with the intent of the reforms. This includes setting prudent capital targets with an adequate management buffer, updating capital projections and internal capital adequacy assessment processes (ICAAPs), and conducting stress testing on the new basis.

The new framework provides the foundations for an unquestionably strong financial system in the years ahead; APRA expects that banks will apply a high degree of rigour and prudence in meeting these standards, to ensure that this strength is sustained.

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[2] There are three updated standards: *Prudential Standard APS 110 Capital Adequacy* (APS 110), *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113).

[3] The term 'bank' is used in this information paper to refer to both banks and other authorised deposit-taking institutions (ADIs). 'Advanced banks' refers to those ADIs that use the internal ratings-based approach (IRB).

A new capital framework for ADIs

Objectives

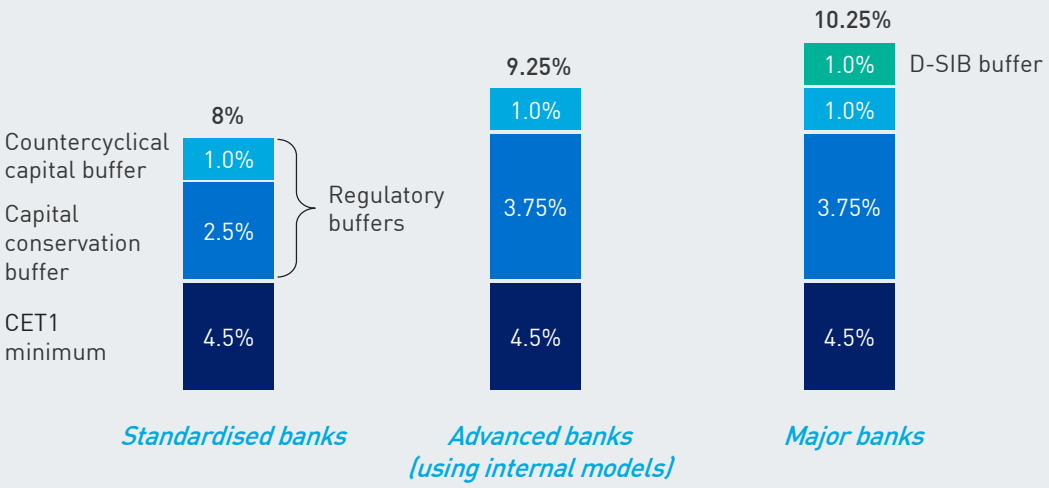
Embedding **unquestionably strong** capital

Aligning to the internationally agreed **Basel III** framework

Key improvements

- Increased flexibility
- Enhanced risk sensitivity
- Stronger support for competition
- Improved transparency
- Increased proportionality

New minimum capital framework from 1 January 2023



Outcomes

Financial safety and stability is strengthened ...

- Framework is **strengthened** in line with 'unquestionably strong' benchmarks
- Regulatory buffers are higher, providing more **flexibility** in stress

... increasing protection against key risks ...

- Capital for housing **increased** relative to other portfolios
- Capital floor supports greater **comparability** and **transparency**

... and reducing burden for smaller ADIs

- **Simplified framework** reduces undue compliance burden and promotes ability of smaller entities to grow and compete

Summary of the framework

Objective	Pre-2023 framework	New framework
Unquestionably strong	Capital ratios are unquestionably strong, but this level is not formally embedded in the framework.	'Unquestionably strong' embedded through minimum capital requirements and buffers.
Basel alignment	APRA standards are consistent with the international Basel II framework, with discretion applied for Australian conditions.	APRA standards updated to align with the Basel III framework, with discretion applied through simpler adjustments for Australian conditions.
Flexibility	Flexibility through capital buffers, with a capital conservation buffer of 2.5 per cent for all banks (and 3.5 per cent for the major banks).	Significant increase in flexibility, with capital conservation buffer (CCB) of 3.5 per cent for standardised banks and 5.75 per cent for the major banks. This includes a 1.0 per cent default setting for the countercyclical capital buffer (CCyB).
Risk sensitivity	Framework is inherently risk sensitive for advanced banks, and simpler for standardised banks.	Enhanced risk sensitivity, with strengthened requirements for residential mortgages and reduced capital for small business lending.
Competition	Several initiatives to support competition already introduced, including changes to requirements for newly licensed banks; a staged approach to accrediting internal models; and increases in mortgage capital for advanced banks.	Additional safeguards built into the framework to support competition, including through better risk sensitivity in the standardised approach, and higher buffers and floors for advanced banks.
Transparency	Australian adjustments not always transparent in risk estimates of advanced banks. No floor on differences in capital requirements between standardised and advanced approaches.	Australian adjustments are simpler and more transparent, improving international comparability. Floor on capital requirements for advanced banks that use internal models. All banks to disclose capital ratios under standardised methodology.
Proportionality	Proportionality rests on differences between standardised and advanced approaches.	Simplified capital requirements for small, less complex standardised banks.

Chapter 1 - Unquestionably strong

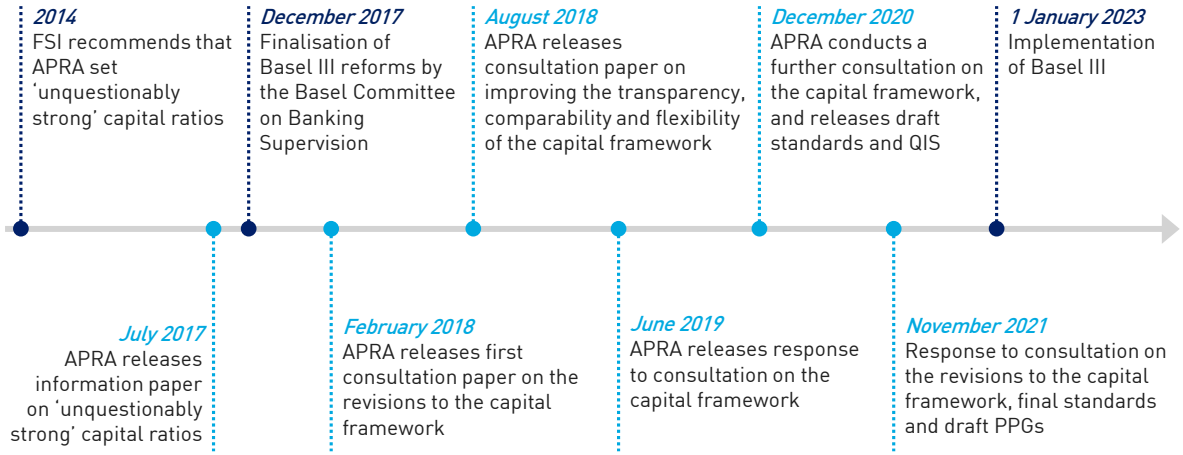
This chapter provides an overview of the framework. It covers the origins and background to APRA's reforms, overall levels of capital and the calibration of unquestionably strong, and expectations for the use of the buffers in periods of stress.

1.1 Origins of the reforms

In 2014, the Financial System Inquiry (FSI) recommended that APRA '*set capital standards such that Australian ADI capital ratios are unquestionably strong*'. The purpose of this target level was to increase the resilience of the banking sector, to ensure it has the strength to absorb losses and continue to provide critical functions to the economy, such as credit and payment services. Capital strength also supports banks in accessing funding through international markets, in good times and bad. The FSI assessed the costs of this regulation would be offset by net economic benefits, and APRA's analysis is that the marginal compliance costs will be low.

In addition to meeting the FSI recommendation, APRA has conducted a comprehensive review of the capital standards to align them with the updated international Basel framework ('Basel III'). While the Basel framework provides a starting point and minimum standards, it also allows jurisdictions to exercise national discretion to customise regulation for local market conditions. APRA's reforms meet the Basel standards, with tailoring to reflect the particular characteristics of the Australian economy, including for example risks arising from the housing market.[4]

Figure 1. Timeline of the reforms



[4] Australia is a member of the Basel Committee on Banking Supervision, which is the international standard-setting body for the prudential regulation of banks. For a summary of how the revised APRA standards align with the Basel III framework, see response to submissions paper, *Finalising the bank capital reforms* (Annex A).

1.2 Overall levels of capital

In July 2017, APRA published benchmarks for the target levels of capital that banks would need to meet to achieve unquestionably strong capital ratios. For the major banks, for example, APRA anticipated that actual CET1 capital ratios would need to increase to 10.5 per cent on average, based on the capital framework at the time.

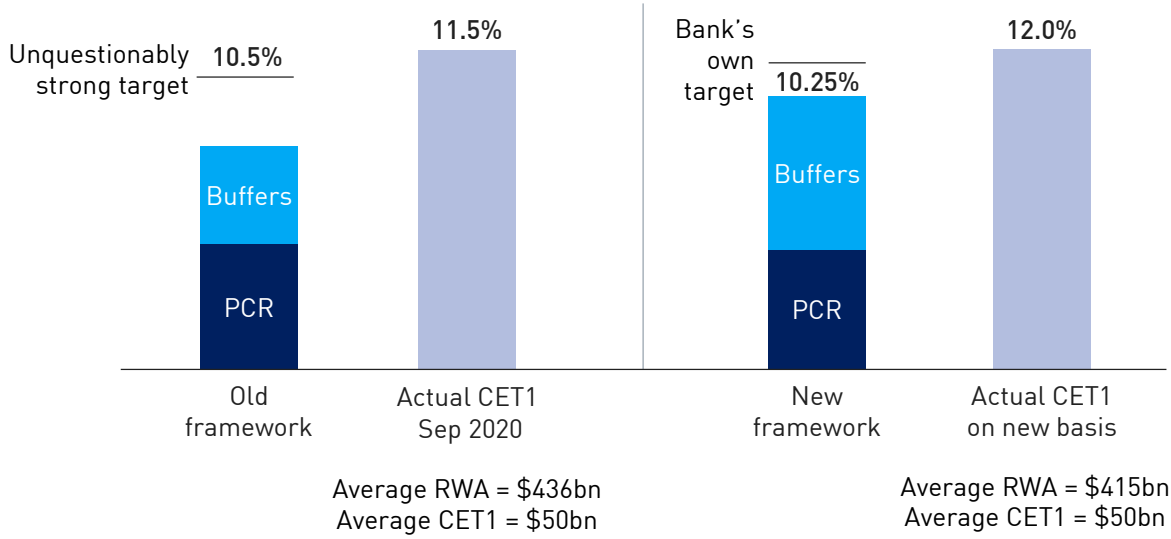
The unquestionably strong benchmarks equated to an increase in average minimum capital requirements of 150 basis points for advanced banks and 50 basis points for standardised banks. The benchmarks were based on judgement, informed by a range of factors, including international comparisons, rating agency methodologies and stress testing.[5]

New capital ratios

APRA has calibrated the new framework to embed these increases in capital requirements, through a combination of additional regulatory buffers and adjustments to risk weights. Reported capital ratios will be higher under the new framework (given lower risk weights in a number of areas), and will more closely align with international peers.[6]

The chart below presents capital ratios for the major banks. APRA expects that the major banks will likely operate with CET1 ratios (calculated under the new methodology) above **11 per cent** from 2023. The exact changes in reported capital ratios will vary by bank given differences in risk profile, and not all should expect to see the same level of adjustments.

Figure 2. Major bank capital ratios: old and new



[5] *Strengthening banking system resilience—establishing unquestionably strong capital ratios*, APRA Information Paper (July 2017). The FSI recommendation that Australian banks should target the top quartile of internationally active banks was also factored into the determination of the benchmarks.

[6] The calibration has been at an industry level, based on assumptions. For advanced banks, the 150 basis points increase has been achieved through higher buffers of 225 basis points, offset by a 5 per cent reduction in risk weights (lifting CET1 ratios by 75 basis points). APRA has factored in further changes in market risk and counterparty credit risk RWAs into the calibration. For standardised banks, the 50 basis points increase is the product of 100 basis points in buffers and a 6 per cent reduction in RWA (50 basis points impact).

1.3 Flexibility for stress

APRA has achieved the strengthening of capital requirements mainly through expanded use of buffers (rather than raising risk weights), providing greater flexibility in the framework. As a result, there will be a significantly larger proportion of capital held in the form of buffers:

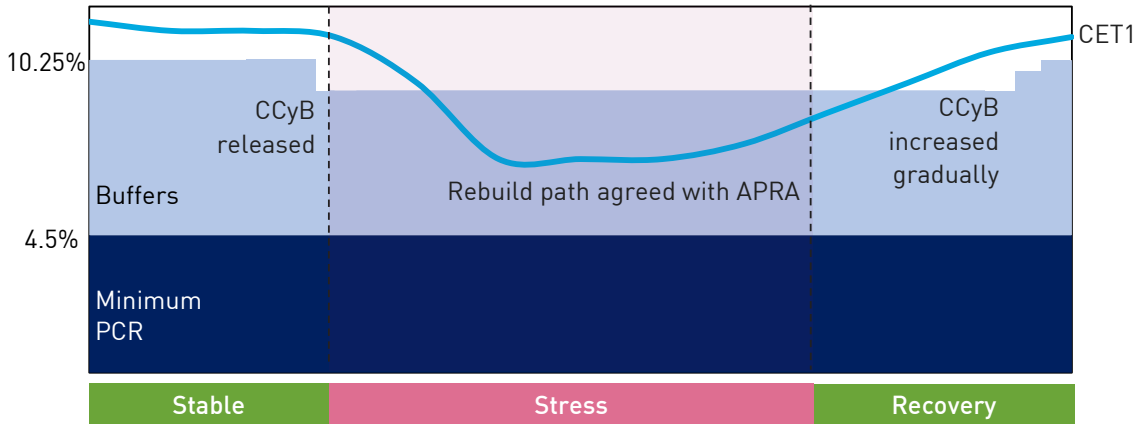
- **a releasable buffer** of 100 basis points through a baseline setting for the Countercyclical Capital Buffer, which may be varied by APRA in the range of 0 – 350 basis points; and
- **additional useable buffers** of 250 – 475 basis points through the Capital Conservation Buffer, with the amount varying depending on the type of bank.

A summary of the capital buffers is outlined in the table below.

Capital components for CET1 (% RWA)	Standardised	Advanced	Majors (D-SIBs)
Minimum Prudential Capital Ratio (PCR)	4.50%	4.50%	4.50%
Capital Conservation Buffer (CCB)	2.50%	3.75%	3.75%
Additional CCB for major banks as D-SIBs			1.00%
Countercyclical Capital Buffer (CCyB)	1.00%	1.00%	1.00%
Total	**8.00%**	**9.25%**	**10.25%**

Capital buffers are designed to allow for banks to operate within the regulatory buffer range in periods of stress, to absorb losses and continue lending without breaching minimum requirements: this is the intent of the capital framework.[7] Regulatory buffers can be used if needed, and APRA does not expect banks to maintain targets above the buffer range in a severe stress. An illustration of how buffers may be used in a systemic stress scenario is presented below, including a capital rebuild path that would be agreed with APRA.

Figure 3. Major bank capital ratios: use of buffers in stress



[7] Larger buffers should also help absorb increases in risk weights driven by deterioration in credit quality. The advanced approach is risk sensitive and banks should plan for some increase in risk weights in stress.

Box 1: Key points for Boards

For directors, accountable for overseeing capital management at banks on the new framework, the key points to note are:

- **capital targets** need to be set, monitored and reviewed at new levels, reflecting the new prudential requirements and the bank's risk appetite;
- **regulatory buffers** are there to be used if needed, as it is important that banks continue to lend to support the economy during periods of stress; and
- **higher risk** lending requires more capital, and APRA's view on higher and lower risk is embedded in the framework (summarised in Chapter 2).

Further guidance on capital management is set out in APRA's prudential practice guides for capital: *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110) and *Prudential Practice Guide APG 110 Capital Adequacy* (APG 110).

Chapter 2 - Risk sensitivity

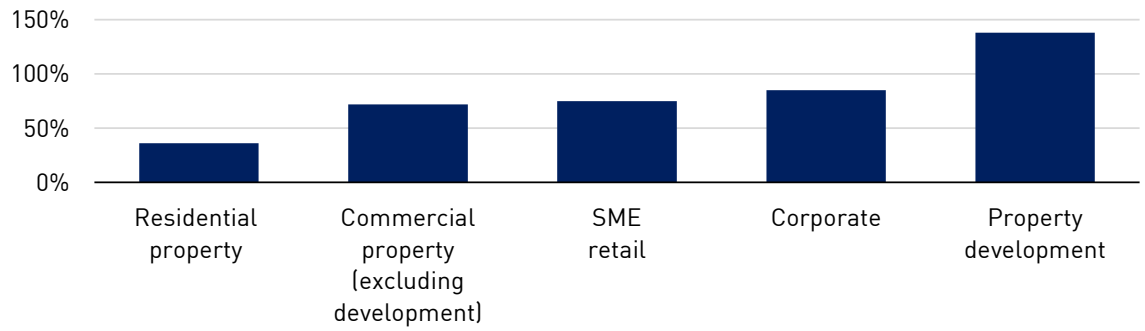
This chapter outlines how APRA has improved the risk sensitivity of the capital framework in key areas, to ensure banks hold an appropriate amount of capital for different types of lending. This is particularly important for residential mortgage lending, given that it is the largest asset class on average for Australian banks.

2.1 Capital for higher risk lending

The capital framework has been designed to allocate higher capital requirements for higher risk lending, and lower requirements for lower risk. This both incentivises banks to lend prudently, and requires more capital to be held for riskier loans that have a higher probability and impact of loss.

Advanced banks determine capital requirements for credit risk by using internal models approved by APRA, while standardised banks apply APRA-set risk weights for different types of lending. Under both approaches, more capital is allocated to higher risk lending, as shown in the chart below.

Figure 4. Capital requirements by type of lending



Weighted-average risk weights for standard property and non-property loans on the standardised approach (QIS data, September 2020).

The capital requirements for different types of lending have been refined in the new framework, to better reflect key risks for Australian banks. A summary of the revised requirements is presented below.

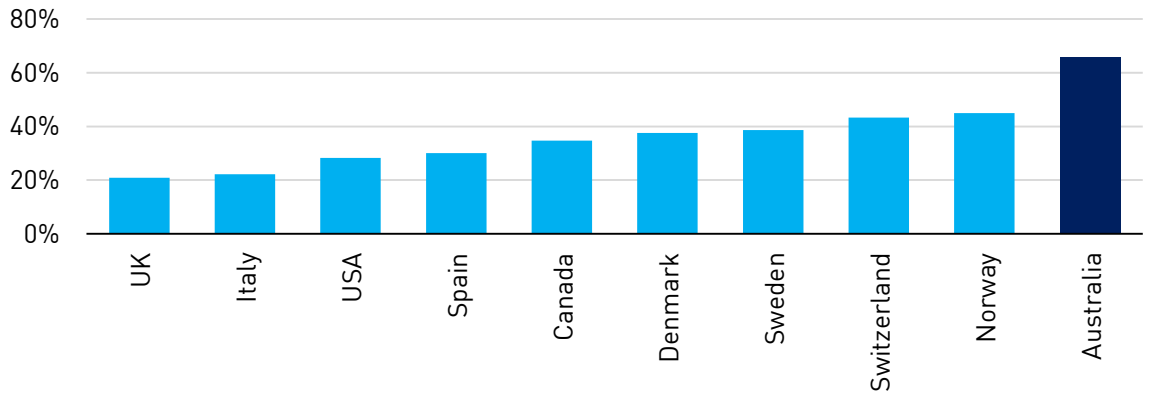
Asset class	Standardised banks	Advanced banks
Residential mortgages	• Loans to owner-occupiers repaying principal and interest are lower risk, and investors loans and interest-only loans are higher risk. • More capital is required for riskier loans, varying by loan-to-valuation ratios (LVR).	• Loans to owner-occupiers repaying principal and interest are lower risk, and investors loans and interest-only loans are higher risk. • Risk weights determined by approved internal models, subject to APRA multipliers and floors.

Asset class	Standardised banks	Advanced banks
Commercial property	• Loans where repayments depend on cash flow from the property are typically higher risk. Capital also varies by LVR.	• Risk weights determined by approved internal models.
Small and medium-sized business	• Small businesses are those with revenue less than $75 million. Capital depends on collateral and credit rating.	• Similar definitions apply as under the standardised approach. Risk weights determined by approved internal models.
Other exposures	• Risk weights prescribed for a range of asset classes.[8]	• Risk weights determined by approved internal models.
New Zealand	• For subsidiaries in New Zealand, risk weights determined by Reserve Bank of New Zealand (RBNZ).	• RBNZ risk weights apply, with APRA adjustments and floors.

2.2 Strengthening capital for residential mortgages

One of the objectives of the new framework has been to strengthen the amount of capital held by banks for residential mortgage lending, given the industry concentration in this asset class. In APRA stress testing, mortgages are a significant driver of overall losses, and typically account for around a third of aggregate bad debts.

Figure 5. Share of residential mortgages on bank balance sheets



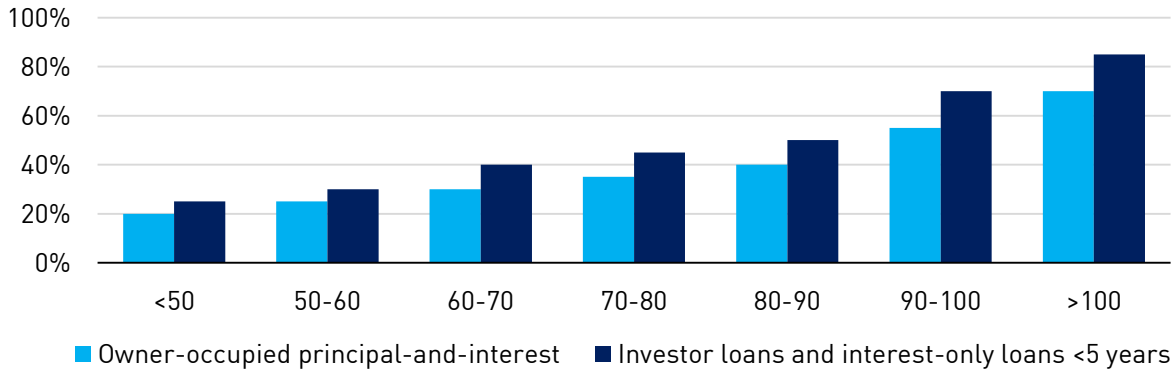
Source: IMF Financial Soundness Indicators. Data as at June 2020.

Under the new framework, APRA has increased capital for residential mortgages relative to other asset classes, and better distinguished higher and lower risk lending. Risk weights for

[8] Asset classes include sovereign, domestic public sector entities, bank, corporate, retail, margin lending, subordinated debt, equity, leases and other exposures. Off-balance sheet exposures measured by credit conversion factors and then risk weighted.

mortgages under the new standardised approach are shown in the chart below.[9] In addition, mortgages with both an interest-only period of 5 years or more and an LVR above 80 per cent are classified as non-standard loans, and require a higher risk weight of 100 per cent.

Figure 6. Standard mortgage risk weights by LVR



2.3 Lending to SMEs

Under the new framework, capital requirements for lending to SMEs have been reduced, with lower risk weights under the standardised approach. The threshold for defining retail SME has also been raised from $1.0 million to $1.5 million in loan size, increasing the volume of loans eligible for lower risk weights under both the standardised and advanced approaches. These new settings are aligned with the Basel framework.

[9] The IRB framework adopts a similar segmentation based on high and low risk segments, with different multipliers applied to generate the appropriate calibration for the Australian market.

Chapter 3 - Competition

This chapter focuses on how the new framework provides additional support to competition in the industry. It outlines the safeguards built into the framework to ensure capital outcomes between advanced and standardised banks do not widen unduly, and how competition in residential mortgage lending has been enhanced.

3.1 Supporting competition

Through the reforms to the bank capital framework, APRA has sought to better support competition between advanced banks that use internal models and standardised banks that use APRA-prescribed risk weights. Under the new framework, APRA has:

- increased minimum capital requirements for advanced banks by 100 basis points more than standardised banks, in line with the unquestionably strong benchmarks;
- required advanced banks to hold higher capital buffers, and apply multipliers to risk weights for higher risk loan types; and
- reduced capital requirements for lower risk mortgage lending by banks on the standardised approach.

While these steps help to support ongoing competition, APRA has intentionally not fully closed the gap in capital requirements between the advanced and standardised approaches. In any framework with different approaches to calculating overall requirements (even if equivalently calibrated at the aggregate level), there will inevitably be some differences in capital requirements at the product level.[10]

Standardised risk weights are intentionally simple and conservative, to cater for a variety of banks and portfolios, whereas advanced approaches are based on more risk sensitive models, and as such are able to identify additional risk characteristics of loans that the simpler standardised approach cannot. APRA believes that there should be an incentive to invest in advanced modelling, given the benefits to risk management that this brings.

3.2 Safeguards in the framework

In addition to changes in the level of capital, APRA has also built safeguards into the framework to ensure the two approaches to capital do not excessively diverge. These are outlined in the table below.

[10] Within the new framework, there are effectively four different cohorts with different methods that determine their capital requirements: D-SIBs that use the advanced approaches; other banks using advanced approaches; banks using the standardised approaches; and banks using the simplified approach.

Key features	Impact
Overall floor	• To avoid excessive divergence, overall advanced bank RWA are subject to a floor of 72.5% of the standardised approach.
Mortgages floor	• Risk weights for mortgages of advanced banks are subject to a floor of 5 per cent.
Transparency	• Advanced banks must calculate and disclose capital on both the advanced and standardised approaches, improving comparability.

The overall capital floor, which caps the disparity between the advanced and standardised approaches, is particularly important. The floor effectively limits the benefit of internal modelling so that RWA under the advanced approach cannot be lower than 72.5 per cent of the equivalent standardised calculation. Disclosure by advanced banks on both approaches will also improve comparability and transparency.

Figure 7. The IRB capital floor

The floor is, however, intended to be a backstop and is not expected to be a consistently binding constraint for all advanced banks on a system basis; if it were consistently binding, this would undermine risk sensitivity and dull incentives to invest in advanced modelling.

3.3 Risk weight comparisons

To assess the difference in capital requirements between advanced and standardised banks, it is important to look at a complete picture. Comparisons based on headline risk weights for specific loan types do not provide the complete picture. In addition to distinct approaches to risk weights, material differences include:

- higher buffers for advanced banks;
- capital required to be held by advanced banks for other risks, such as interest rate risk in the banking book;
- technical adjustments that advanced banks are required to make, such as for expected losses and credit conversion factors; and
- differences in how risk weights change over time, including during periods of stress.

Through consultation with industry on the reforms, APRA estimated that the average pricing differential for residential mortgages between advanced and standardised banks, which could be attributed to differences in capital requirements, would be in the order of 5 basis points. Based on the final calibration, APRA does not expect this differential to have changed.

Chapter 4 - Transparency and proportionality

This chapter outlines how the framework supports transparency and proportionality. This has been achieved by better alignment with the international Basel framework, and the introduction of simplified capital requirements to reduce cost and burden for small, less complex banks.

4.1 Improved transparency

The new framework improves transparency and comparability by better aligning to the Basel framework. International comparability is important for investors, to provide a clear and transparent view of the strength of Australian banks.

Capital requirements will still vary across jurisdictions, however, given the scope for national discretion within the Basel framework. Where APRA has exercised discretion to reflect conditions in the Australian market, this has been implemented through simple and more transparent adjustments to the framework. The main differences between the APRA standards and the minimum Basel framework are summarised below.

Framework	Features of APRA standards not required by Basel	Rationale
Capital buffers	• Additional CCB for advanced banks. • CCyB set at a baseline level of 100 basis points.	Unquestionably strong and flexibility.
Residential mortgages	• Loans categorised as either 'owner-occupiers on principal and interest repayments' or 'other mortgages' (such as investor and interest-only), rather than the Basel definition of whether repayments are dependent on cash flows from the property.	More reflective of risks in Australian market.
Modelling parameters	• Multipliers and floors for mortgage risk weights. • Scalar applied to overall risk weights.	Unquestionably strong and supports competition.

The requirement for advanced banks to disclose their regulatory capital ratios under the standardised approach is also expected to support easier comparisons across banks domestically and internationally.

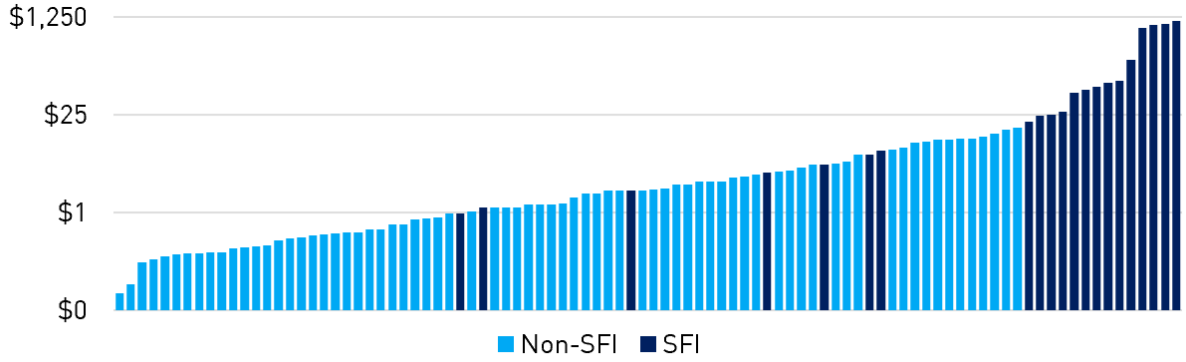
In 2023, APRA plans to undertake a more detailed international capital comparison study comparing the capital position of the Australian major banks against international peers. The study is intended to examine differences in more depth, given changes in capital frameworks in other jurisdictions, and help to promote consistency in how comparisons are made with international banks.

4.2 Simplified capital requirements

APRA has introduced a set of simplified capital requirements that would apply to small, less complex banks, which streamlines the standards set by the Basel Committee. The Basel framework was developed primarily for large, internationally active banks and, while widely used around the world, may not always be appropriate for smaller domestic banks. In some cases, the cost of implementing the full standardised approach for these banks may outweigh the benefits of prudential safety in doing so.

Under the new framework, banks with total assets below $20 billion are eligible to use the simplified requirements, and would be categorised as non-significant financial institutions (non-SFIs). These banks must be domestic banks, with no trading book activities, offshore businesses or international funding sources. There are likely to be around 70 banks that will benefit from the simplified requirements, which are summarised in the table below.

Figure 8. Banks eligible for simplified requirements ($ billion assets, log scale)



Based on March 2021 data and excludes foreign ADIs and purchased payment facility providers.

Risk area	Streamlined requirements
Credit risk	Consistent with standardised approach.
Operational risk	Simple, flat rate add-on of 10 per cent of total credit and securitisation RWAs.
Counterparty credit risk	No counterparty credit risk capital requirements or reporting.
Interest rate risk in the banking book	No specific risk management requirements, with some reporting to allow APRA supervisors to monitor the risk.
Leverage ratio	No leverage ratio requirements or reporting.
Public disclosures	Replacing disclosure requirements with an APRA data publication, to be confirmed during consultation in 2022.

APRA is considering how to build on the simplified framework for capital, expanding it to other prudential requirements, in order to further enhance proportionality in the prudential framework and reduce the cost of compliance for the industry.

APRA