Discussion Paper

Adoption of International Financial Reporting Standards

Prudential Approach

2. Tier 1 Capital and Securitisation

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Australian Prudential Regulation Authority

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Preamble

Australian reporting entities are adopting Australian equivalents of International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005. The accounting standards are available from the Australian Accounting Standard Board's (AASB) web site (www.aasb.com.au).

In February 2005, APRA published a discussion paper, *Adoption of International Financial Reporting Standards: Prudential Approach–1. Fair Value and Other Issues*, which addressed the prudential implications of a number of specific IFRS-related changes to Australian Accounting Standards. That paper foreshadowed a separate discussion paper to deal with the treatment of eligible Tier 1 capital instruments and securitisation.

In developing its proposed approach to Tier 1 capital instruments and securitisation, APRA has taken into account the objectives of IFRS, the use of different capital instruments in Australia, the position of other prudential standard-setters and regulatory bodies as well as the introduction of the new global capital adequacy regime, known as the Basel II Framework.

The two discussion papers will be followed by consultation on changes to prudential standards and prudential rules made under the *Banking Act 1959*, the *Insurance Act 1973* and the *Life Insurance Act 1995*, and reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

APRA welcomes comments on the proposals in this discussion paper, which should be submitted in electronic form no later than 28 October 2005 to:

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Glossary

AASB	Australian Accounting Standards Board
ADI	Authorised deposit-taking institution
AGN	ADI guidance note
APRA	Australian Prudential Regulation Authority
APS	ADI prudential standard
Basel Accord	The international framework for capital adequacy published by the Basel Committee on Banking Supervision in 1988
Basel Committee	Basel Committee on Banking Supervision
EMVONA	Excess of market value over net assets
GI	General insurer authorised under the *Insurance Act 1973* (the Insurance Act), excluding a branch of a foreign general insurer as defined by the Insurance Act.
GGN	GI guidance note
GPS	GI prudential standard
IFRS	International Financial Reporting Standards
Insurance Act	*Insurance Act 1973*
MCR	Minimum capital requirement for a general insurer
SPV	Special purpose vehicle
Standards/Prudential Standards	References to the prudential standards applicable to ADIs or general insurers, as the context implies.

Summary of key proposals

Tier 1 capital

The reclassification of debt and equity instruments under IFRS has prompted APRA to review its treatment of innovative capital instruments in assessments of capital adequacy. APRA's aim is to ensure that the financial position of regulated institutions is underpinned by adequate levels of high quality capital. The review has taken into account the evolution of innovative capital instruments in Australia as well as the decisions of the Basel Committee on Banking Supervision and regulatory practice in major jurisdictions.

APRA proposes to de-couple the definition of capital instruments eligible for Tier 1 capital from Australian Accounting Standards. In addition, APRA proposes to refine its approach to instruments qualifying as regulatory capital and introduce a three-component structure for Tier 1 capital:

- 'Fundamental Tier 1' will comprise ordinary shares, retained earnings, general reserves, current year's earnings net of expected dividends and tax expenses, minority interests and, for general insurers, excess provisions for policy liabilities;
- 'Residual Tier 1' will comprise all other items qualifying for Tier 1 status, including 'pure' preference shares and innovative Tier 1 instruments; and
- 'Innovative Tier 1' will form a sub-category within Residual Tier 1, reserved for innovative instruments. Innovative capital includes, for example, any instrument that may contain an incentive for the issuer to call, such as a step-up provision or an option to convert into ordinary shares; any instrument which is indirectly issued through a special purpose vehicle (SPV); or any other Tier 1 instrument not representing 'shares'.

Those instruments eligible to be included in Tier 1 capital will be subject to the following limits on the composition of Tier 1 capital:

- Fundamental Tier 1 must comprise at least 75 per cent of net Tier 1 capital;
- Residual Tier 1 will be limited to 25 per cent of net Tier 1 capital; and
- Innovative Tier 1 will be limited to 15 per cent of net Tier 1 capital.

For the purpose of applying these limits, net Tier 1 capital is Total Tier 1 capital net of all current Tier 1 deductions (such as goodwill and other intangible assets) and any further deductions from Tier 1 capital arising from the implementation of IFRS and other prudential policy changes.

APRA is proposing to introduce more flexibility into its approach to innovative capital by allowing Innovative Tier 1 capital instruments (whether designated as 'shares' or not) to be issued directly by ADIs and general insurers. Issuers may continue to use SPVs but all instruments issued through a SPV will continue to be classified as Innovative capital.

In addition, APRA is proposing to remove the current mandatory conversion requirements for directly issued capital instruments eligible for inclusion as Innovative Tier 1 or Upper Tier 2 capital. Instead, APRA intends to rely on the subordination requirements and additional loss absorption criteria that it proposes to include in the prudential standards.

Subject to consultation, APRA proposes to introduce amended prudential standards and guidance notes on the measurement of capital that would come into force from 1 July 2006. These changes would give effect to the de-linking of prudential requirements from Australian Accounting Standards; introduce additional loss absorption criteria for Innovative Tier 1 capital instruments; allow for direct issuance of Innovative Tier 1 capital instruments; and remove mandatory conversion requirements for directly issued instruments. The standards would provide that the proposed limits on Residual and Innovative Tier 1 capital would become effective on 1 January 2008, to coincide with the implementation of the Basel II Framework. For ADIs materially affected by the proposed changes, APRA intends to grant up to a further two-year transition period, until 1 January 2010, in respect of innovative capital instruments in excess of the proposed limits as at the date of this discussion paper (and approved by APRA as Tier 1 capital).

Securitisation

APRA proposes to de-couple the assessment of securitised assets of authorised deposit-taking institutions (ADIs) for capital adequacy purposes from the accounting treatment of these assets. The changes would be effective from 1 July 2006. APRA is also proposing:

- a review of its current 'clean sale' requirements for securitised assets and its 'separation' requirements for SPVs;
- exclusion of securitised assets from consolidated reporting to APRA together with a separate reporting form for selected securitisation information; and
- application of its securitisation principles for ADIs to assess securitisations within the general insurance industry, but deferring a prudential standard until industry practice becomes more established.

Tier 1 capital

Introduction

IFRS introduces a stricter definition of equity that could result in certain financial instruments currently classified as equity being reclassified as debt. As APRA's prudential framework for capital adequacy is currently linked to accounting standards, the adoption of IFRS, on its face, may restrict the range of instruments that meet APRA's capital requirements. APRA has therefore been considering whether to carry the stricter IFRS approach through to the definition of regulatory capital or to 'de-couple' the prudential framework from accounting standards.

In its considerations, APRA has been mindful of the view of the Basel Committee that, in relation to the classification of equity and debt, the current regulatory capital treatment of national supervisors should be maintained for the time being. APRA concurs generally with this view.

At the same time, the increasing issuance of often complex hybrid capital instruments in Australia and a growing international consensus on rules relating to the 'quality' of capital instruments has led APRA to undertake a broader review of its approach to capital. This broader review has focussed on:

- whether, in light of recent market developments, there is a need to revise APRA's capital adequacy requirements to ensure that adequate levels of high quality capital underpin the financial position of ADIs;
- whether APRA should harmonise its requirements with the limits on innovative capital decided by the Basel Committee in 1998 and progressively adopted by a number of major countries; and
- what degree of harmonisation in the capital requirements for ADIs and general insurers is appropriate.

Background on Tier 1 rules in Australia

APRA seeks to ensure that APRA-regulated institutions have adequate levels of capital to support their business and, thereby, reduce their risk of failure. Capital represents the financial resources available to absorb unforeseen losses. It acts as a means of strengthening the safety and soundness of financial institutions and the financial system more generally, and provides protection for beneficiaries (depositors and policyholders). It is an agreed starting point for all prudential supervisors that regulated institutions should maintain their capital predominantly in the highest quality form.

The desirable features of high quality capital include: providing a permanent and unrestricted commitment of funds; being freely available to absorb losses; not imposing any unavoidable servicing charge against earnings; and ranking behind the claims of depositors and other creditors in the event of a wind-up. Based on these criteria, the highest quality form of capital is ordinary shares, retained earnings and general reserves. These items are the fundamental building-blocks of regulatory capital and, for this reason, are referred to as 'fundamental capital'. Over recent years, institutions have been developing other capital instruments which satisfy the broad features of high quality capital, but not to the same extent as fundamental capital.

Tier 1 capital for ADIs

The 1988 Basel Capital Accord developed by the Basel Committee, which forms the basis for APRA's capital adequacy requirements for ADIs, recognises two major components of capital. One is Tier 1 capital, comprising ordinary shares, retained earnings and general reserves. The other is 'supplementary' or Tier 2 capital, which includes undisclosed reserves, revaluation reserves, general provisions, hybrid capital instruments and subordinated debt.

Consistent with the Basel Capital Accord, APRA requires ADIs to hold an amount equal to at least eight per cent of risk-weighted assets in Tier 1 and Tier 2 capital, with at least half of capital comprising Tier 1 capital. As a practical matter, APRA expects ADIs to hold a buffer of capital above these minimum requirements and nothing in the proposals in this discussion paper will change that general expectation.

Within its capital framework, the Basel Committee initially recognised only non-cumulative perpetual (irredeemable) preference shares as being of sufficient strength and quality for inclusion in Tier 1 capital alongside fundamental capital. In October 1998, however, the Basel Committee noted that other capital

instruments—so-called 'innovative' capital instruments —were being issued with the aim of generating Tier 1 capital, and it decided to limit acceptance of these instruments in Tier 1. These innovative instruments have similarities to fundamental capital in terms of permanence and subordination to the claims of depositors and other creditors. Typically, however, they also have some debt-like characteristics: contractual or 'coupon' payments are fixed, generally at a margin over a bank debt reference rate and, although perpetual in theory, they contain certain payment features (e.g. a 'step-up' provision in coupon payments as well as call options) which signal a *de facto* maturity or 'tenor' (usually ten years) to investors. Innovative instruments typically pay a lower coupon than do traditional preference shares due to their synthetic maturity. Many innovative instruments have achieved tax deductibility on coupon payments which would not be available to issues of ordinary shares.

In its 1998 determination, the Basel Committee confirmed that fundamental capital should remain the predominant form of Tier 1 capital and that banks should be able to meet minimum capital ratios without undue reliance on innovative instruments. Accordingly, it limited innovative capital instruments to a maximum of 15 per cent of Tier 1 capital. It also required, inter alia, that the main features of such instruments be easily understood and publicly disclosed.

APRA gave effect to the Basel Committee's determinations in guidelines issued in June 1999 and amendments to *APS 111 Capital Adequacy: Measurement of Capital* in September 1999. However, instead of establishing a limit for innovative instruments, APRA combined non-cumulative irredeemable preference shares and innovative instruments under a single, but higher, limit of 20 per cent of Tier 1 capital.[1] At that time, ADIs in Australia had issued only a small amount of innovative instruments and APRA saw its limit as a simple but more prudent limit on the issue of non-fundamental ('residual') Tier 1 capital instruments. In principle, however, the limit allowed innovative instruments to comprise up to 20 per cent of Tier 1 capital.

Tier 1 rules for general insurers

APRA's regulatory capital regime for general insurers is closely modelled on the ADI rules and came into effect as part of reforms to the prudential framework for general insurance from 1 July 2002.

The Tier 1 rules for general insurers are similar to the requirements for ADIs but with certain differences to reflect the specific nature of the general insurance industry:

- subject to the modifications outlined below, the starting point for measuring capital is the definition of Tier 1 and Tier 2 capital applied to ADIs;
- rather than expressing the capital requirement as a percentage of risk-weighted assets, the capital regime for general insurance requires general insurers to meet a minimum capital requirement (MCR) reflective of the insurer's risk profile (calculated as the sum of capital charges for investment risk, insurance risk and the maximum event retention). As with ADIs, at least 50 per cent of the MCR must be held in the form of Tier 1 capital. APRA expects general insurers to hold an additional buffer of eligible capital (generally around 20 per cent of the MCR) and many insurers have set higher internal targets to reflect their individual risk profile; and
- *GPS 210 Liability Valuation for General Insurers* requires general insurers to value their insurance liabilities at a minimum 75 per cent level of sufficiency, meaning that provisions for policy liabilities should be sufficient in at least 75 per cent of projected circumstances. Provisions for policy liabilities in excess of the 75 per cent probability of sufficiency (adjusted for tax) can be included as Tier 1 capital.

The implications of IFRS

Under APRA's current prudential standards, a Tier 1 capital instrument must be treated as equity under Australian Accounting Standards (as they applied in relation to reporting periods that began immediately

[1] APS 111 expresses the limit, equivalently, along the following lines: an instrument is not eligible for inclusion in Tier 1 capital where it would result in an aggregate amount of innovative capital instruments and non-cumulative irredeemable preference shares exceeding 25 per cent of all other Tier 1 capital components (Paragraph 11(i)).

before 1 January 2005) and be reported as such in the entity's published financial statements, except where an alternative treatment has been agreed with APRA.

AASB 132 Financial Instruments: Disclosure and Presentation introduces a stricter definition of equity and, on initial adoption of IFRS, will result in certain preference shares and hybrid instruments currently classified as equity (and included in Tier 1 capital) being reclassified as liabilities. The IFRS approach reflects a perception that these instruments function economically more as debt instruments than as equity. Contractual appearances of perpetuity notwithstanding, hybrid/innovative issues are typically structured and priced like term debt, and are viewed by investors as an interest-bearing instrument, not as equity.

The past five years have seen a dramatic growth in the amount of innovative capital instruments issued by ADIs. In December 2000, innovative instruments and non-cumulative irredeemable preference shares on issue totalled around $1.6 billion, representing a little more than two per cent of (gross) Tier 1 capital of the issuing ADIs. By March 2005, the figure had risen to around $15 billion, representing around 15 per cent of the Tier 1 capital of these issuers. The growth in these instruments provided some 42 per cent of the total growth of $31.6 billion in Tier 1 capital for these issuers over the period. For a small number of ADIs, innovative capital on issue exceeded APRA's Tier 1 limits (the excess is treated as Upper Tier 2 capital). Authorised general insurers have made only very limited use of innovative capital instruments, although some holding companies have issued such instruments.

If APRA were to maintain the current link between its prudential requirements and accounting standards, the adoption of IFRS would mean that a significant portion of the current stock of non-cumulative irredeemable preference shares and innovative instruments might no longer be eligible for inclusion in Tier 1 capital, depending upon the classification of the instrument adopted by an ADI and approved by its auditors. This would have a significant impact on regulatory capital and other requirements. APRA does not see this as a sensible outcome since the substance of these instruments, and the reasons why prudential regulators have been prepared (within strict limits) to accept them as Tier 1 capital, have not changed. This has been recognised by the Basel Committee and other regulators.

APRA therefore proposes to 'de-couple' the prudential treatment of capital instruments from Australian Accounting Standards. At the same time, APRA is proposing to adopt additional loss absorption criteria which must be satisfied for innovative instruments to be classified as Tier 1 capital. Such criteria seek to reduce doubt that the instrument is available to absorb losses on an on-going basis. The criteria include limitations on payments of dividends or interest should this cause an issuer to become insolvent or breach (where relevant) depositor preference provisions in the *Banking Act 1959*, and provisions strengthening subordination criteria as they relate to any potential actions with respect to solvency or appointment of a statutory manager under the *Banking Act 1959*. The introduction of these criteria will not affect the classification of existing innovative issues nor will they affect, to any significant extent, the characteristics of current issues which make them eligible Tier 1 capital. They may, however, result in the need for amendments in documentation for new innovative issues.

Proposed amendments to Tier 1 rules

Over the past five years, ADIs have virtually ceased the direct issuance of 'pure' preference shares (i.e. non-cumulative irredeemable preference shares without innovative capital features) and the single limit applied by APRA on the issue of residual Tier 1 capital instruments has been filled by the issue of innovative instruments. In many cases, these issues have accompanied a run-down in ordinary shares through share buy-back programs.

Against this background, APRA has concerns about the evolution of innovative capital instruments in Australia and the ability of more recent versions of these instruments to meet APRA's expectations of high quality capital, particularly in times of stress. Though these instruments are structured to have the same loss absorption capacity as shareholders' funds (i.e. payments can be made without penalty), the instruments tend to be viewed and priced by markets

as if they are term-dated debt securities. Experience has shown that markets often expect (and price accordingly) that instruments with step-ups will be routinely redeemed by the issuer prior to the step-up date rather than have to pay the stepped-up rate of interest. With such expectations, failure to redeem may have an adverse impact on market confidence in the institution. In other circumstances, market pressures could effectively see an issuer deemed to be in default it if missed an expected coupon payment, even if there were no legal obligation to pay. The pressure on APRA and the issuing institution to ensure payments are made could be substantial. Hence, the desired quality of a Tier 1 instrument that it be able to absorb losses may be found wanting under duress.

APRA also notes the growing complexity in the structure of recent innovative instruments. Some have involved special purpose vehicles (SPVs) in multiple domiciles, giving rise to legal complexities because issuers and ultimate investors operate across a number of jurisdictions; some have involved the use of intricate embedded derivative-like features to calculate step-ups. Such complexity also raises doubts about how innovative instruments will perform as high quality capital at times of financial stress, particularly given that the instruments have not been tested under these conditions in Australia. Growing complexity is also at odds with the Basel Committee's requirement that the main features of innovative instruments must be easily understood, from both an institutional and investor perspective.

Uncertainties about the qualities of innovative capital instruments have led prudential regulators in all major jurisdictions to endorse the Basel Committee's 1998 decision to limit innovative capital instruments to a maximum of 15 per cent of Tier 1 capital. This limit is re-affirmed by the Basel Committee in the Basel II Framework. Most of these jurisdictions have moved to a three component rule in their capital adequacy regimes:

- shareholders' funds (i.e. ordinary shares, retained earnings and general reserves) always qualify as Tier 1;
- innovative capital instruments are limited to 15 per cent of Tier 1 capital; and
- 'pure' preference shares are normally included in Tier 1 capital, within limits ranging up to 50 per cent of Tier 1 capital.

In reviewing its approach to Tier 1 capital, APRA has taken into account recent market developments, the level and composition of capital held by banks in other jurisdictions and the consensus of prudential regulators around the Basel Committee's 1998 limit. APRA has concluded that it can no longer see a case for maintaining a more generous Tier 1 limit on innovative capital instruments than is now applied in major jurisdictions. Accordingly, APRA is proposing to revise its Tier 1 capital rules to bring Australia into line with the Basel Committee's approach, by more clearly specifying the definitions of Tier 1 capital and amending the Tier 1 limits. The new rules would apply to both ADIs and general insurers.

Tier 1 definitions

Under APRA's proposed approach, Tier 1 capital will have three components:

- 'Fundamental Tier 1', which is ordinary shares, retained earnings, general reserves, current year's earnings net of expected dividends and tax expenses, minority interests and, for general insurers, excess provisions for policy liabilities;[2]
- 'Residual Tier 1', which is all other items qualifying for Tier 1 status, including pure preference shares (non-cumulative irredeemable preference shares without innovative capital features) and instruments included in Innovative Tier 1; and
- 'Innovative Tier 1', which is a sub-category of Residual Tier 1 reserved for innovative instruments. Innovative capital includes any instrument which may contain an incentive for the issuer to call, such as a step-up provision or an option to convert into ordinary shares; any instrument which is indirectly issued through an SPV; or any other Tier 1 instrument not representing 'shares'.

'Total Tier 1' is the sum of Fundamental Tier 1 and Residual Tier 1.

[2] For ADIs, this definition is identical to items 4(a)–(e) in the definition of Tier 1 capital in *APS 111 Capital Adequacy: Measurement of Capital*.

Tier 1 limits

Under APRA's current Tier 1 rules, non-cumulative irredeemable preference shares and innovative capital instruments are limited to 20 per cent of Tier 1 capital. APRA proposes to replace this limit with:

- a limit on Innovative Tier 1 of 15 per cent of Tier 1 capital; and
- a limit on Residual Tier 1 of 25 per cent of Tier 1 capital.

The increased limit for Residual Tier 1 will allow for increased, though not unlimited, issues of 'pure' preference shares. Such a limit is warranted because, although they are shares in legal form and carry no legal obligation to pay dividends, failure to make a payment on a preference share can threaten the financial position of the issuer by endangering its ratings and limiting its ability to raise additional capital.

Tier 1 deductions

In calculating their regulatory capital ratios, ADIs are required to deduct intangibles (including goodwill and certain types of capitalised expenses), future income tax benefits and certain equity investments from Tier 1 capital. Hence, Tier 1 capital ratios are expressed **net** of deductions. The deductions are required because the items concerned are of uncertain value and may not be available to protect depositors should an ADI come under stress; in the case of equity investments, deductions are required to avoid double-gearing within a group.

APRA proposals on IFRS set out in its February 2005 discussion paper will, if implemented, increase the number of items to be deducted from Tier 1 capital, particularly through the expensing of EMVONA and the treatment of employer-sponsored defined benefit fund surpluses and deficits. Changes associated with the Basel II Framework will also have an impact on deductions from Tier 1 capital for ADIs.

Although Tier 1 capital **ratios** are calculated net of deductions, APRA's current rules do not take the same approach to the limits currently applied to the **composition** of Tier 1 capital. APRA's limit on the issue of non-cumulative irredeemable preference shares and innovative capital is calculated on **gross** Tier 1 capital, i.e. before deductions are made. As a consequence, ADIs have been able to raise a higher level of residual Tier 1 capital to meet deductions than would otherwise be the case. This allows ADIs, in effect, to leverage fundamental capital and can lead to a dilution in the quality of Tier 1 capital where ADIs have large deductions.

In the context of the Basel II Framework, the Basel Committee has confirmed that its 15 per cent limit on innovative capital instruments is calculated on Tier 1 capital, net of goodwill. Prudential regulators in major jurisdictions also calculate innovative capital limits on Tier 1 capital after deductions; most require a larger number of deductions than simply goodwill and apply the same deductions for calculating regulatory capital ratios and the composition of Tier 1 capital.

APRA has also concluded that the deductions from Tier 1 capital used for calculating regulatory capital ratios and the composition of Tier 1 capital should be the same. Accordingly, it proposes to make the following changes to its Tier 1 limit structure:

- limits will be calculated in terms of net Tier 1 capital, i.e. Tier 1 capital after deductions;
- the limit on Residual Tier 1 will be 25 per cent of net Tier 1 capital; and
- the limit on Innovative Tier 1, which forms a component of Residual Tier 1 capital, will be 15 per cent of net Tier 1 capital.

Supporting rule changes

Direct issuance

Currently, APRA requires that innovative capital instruments must be issued through a SPV, in terms of *AGN 111.3 Criteria for Capital Issues Involving use of Special Purpose Vehicles*. At the time this requirement was introduced, international supervisory practice favoured indirect issuance because of concerns about banks issuing non-share capital instruments in their own right. Over recent years, the growing complexity of SPV structures for issuing capital instruments has led to a rethinking of this approach. Prudential regulators in most major jurisdictions now accept

non-share capital instruments issued directly by the institution as innovative capital in Tier 1, on the basis that directly-issued instruments may be more transparent and certain in their operations, and hence carry less risk, than instruments issued indirectly.

Against this background, APRA proposes to introduce more flexibility into its approach to innovative capital by allowing Innovative Tier 1 capital instruments (whether designated as 'shares' or not) to be issued directly by ADIs and general insurers. Issuers may continue to use SPVs but all instruments issued through a SPV will continue to be classified as innovative capital.

Conversion requirements

In conjunction with current requirements for indirect issuance, APRA also requires Tier 1 capital instruments issued by SPVs to convert into ordinary shares or non-cumulative irredeemable preference shares of an ADI (or its relevant subsidiary), when specified trigger events occur. This mandatory conversion requirement is aimed at reducing the risk that indirect issues will not function as Tier 1 capital when required, particularly with respect to loss absorption. A similar mandatory conversion requirement applies to Upper Tier 2 hybrid capital instruments.

If APRA's proposals on direct issuance are implemented, there appears no strong case to require mandatory conversion of directly issued innovative/hybrid capital instruments included in Tier 1 (or Upper Tier 2) capital into shares. Mandatory conversion would not alter an institution's overall level of capital and, because of its dilution effects, could make it more difficult for an institution, at a time of stress, to issue additional high quality capital in the form of ordinary shares. APRA therefore proposes to remove the mandatory conversion requirement for directly issued capital instruments eligible for inclusion as Tier 1 or Upper Tier 2 capital. Instead, APRA intends to rely on the subordination requirements and additional loss absorption criteria that it proposes to include in the prudential standards.

These changes would allow mutually owned institutions such as building societies and credit unions, within the limits on the composition of Tier 1 capital proposed by APRA, to issue innovative capital on a comparable basis to listed entities. Mutually owned institutions cannot readily issue ordinary or preference shares and hence cannot meet APRA's current mandatory conversion requirements.

Because of the additional risks involved in SPV structures, the mandatory conversion requirements currently applying to capital instruments issued via a SPV will continue.

Implementation

Subject to consultation, APRA proposes to introduce amended prudential standards and guidance notes on the measurement of capital that would come into force from 1 July 2006. These changes would give effect to the de-linking of prudential requirements from Australian Accounting Standards; introduce additional loss absorption criteria for Innovative Tier 1 capital instruments; allow for direct issuance of Innovative Tier 1 capital instruments; and remove mandatory conversion requirements for directly issued instruments. The standards would provide that the proposed limits on Residual and Innovative Tier 1 capital would become effective on 1 January 2008, to coincide with the implementation of the Basel II Framework.

For ADIs materially affected by the proposed changes, APRA intends to grant up to a further two-year transition period, until 1 January 2010, to allow these institutions to come within the proposed limits largely through expected growth in retained earnings. Current analysis indicates that no ADI or general insurer will exceed the proposed 25 per cent limit on Residual Tier 1 capital after changes associated with Basel II, IFRS and APRA's conglomerates policy are taken into account. However, some ADIs may exceed the proposed 15 per cent limit on Innovative Tier 1 capital as at 1 January 2008. In these cases, APRA proposes to continue treating holdings of innovative capital instruments as Tier 1 capital (including, as at the date of this discussion paper, any excess over the proposed limit arising from instruments approved by APRA as Tier 1 capital), up until 1 January 2010. It is not APRA'S intention, during any approved transition period, to downgrade to Tier 2 capital any affected

instruments currently accepted as Tier 1 capital. At the same time, ADIs outside the proposed new limits should not seek to move further away from them. Hence, from the date of this discussion paper, any new issues of innovative capital instruments which would take institutions above, or further above, the proposed Tier 1 limits will not be eligible for inclusion in Tier 1 capital when the limits formally take effect from 1 January 2008.

APRA also proposes that general insurers be required to meet the amended capital adequacy requirements from 1 July 2006, with similar transition arrangements. No general insurer is expected to exceed the proposed 15 per cent limit on Innovative Tier 1 capital as at 1 January 2008.

The proposals in this discussion paper look at the issue of capital quality in terms of the features of the underlying capital instruments. Another dimension of capital quality, in a conglomerate group involving an APRA-regulated entity, relates to the nature of the capital contributed to the entity by a non-operating holding company or commercial parent. This dimension of capital is the subject of separate consultations based on APRA's discussion paper, *Prudential Supervision of Corporate Groups Involving General Insurers*, released in May 2005.

Securitisation

Securitisation involves the pooling of assets (or interests in assets) usually in a SPV, which is funded by the issue of securities. In Australia, asset securitisation —particularly involving residential mortgages—has evolved rapidly over the past decade and ADIs have been active participants. An ADI may sell selected assets into a SPV and thereby substantially eliminate its exposure to the credit risks and rewards attached to the assets (known as 'clean sale'). An ADI may also, however, retain an operational role in managing the assets for the securitisation vehicle, in providing certain warranties with respect to assets sold or in providing other facilities or functions for the securitisation vehicle. APRA has established requirements relating to the extent of such ongoing involvement to determine whether an ADI can be relieved of the need to hold capital in support of assets sold to SPVs.

The current securitisation rules for ADIs are set out in *APS 120 Funds Management and Securitisation* and associated guidance notes. APS 120 emphasises the need for ADIs to achieve a 'clean sale' of securitised assets and 'separation' of SPVs. *AGN 120.3 Purchase and Supply of Assets* allows assets sold to a SPV to be excluded from capital adequacy calculations if, inter alia, ADIs receive confirmation from their external auditors that any obligations, risks or rewards relating to the assets sold will be transferred to the SPV. Similarly, AGN 120.1 Disclosure and Separation links capital treatment to the consolidation criteria in Australian Accounting Standards.

AASB 139 Financial Instruments: Recognition and Measurement introduces more stringent requirements on removal from the balance sheet ('de-recognition') of financial assets sold to securitisation vehicles. Assets are tested not only in terms of the transfer of risks and rewards but also in terms of continuous involvement. These de-recognition tests are likely to result in financial assets (such as mortgages) that have been securitised being brought back onto ADI balance sheets. However, IFRS transitional arrangements provide that assets removed from financial statements prior to 1 January 2004 are not required to be brought back where they fail the de-recognition tests on adoption of AASB 139.

APRA is satisfied that securitisation programs which meet its clean sale and separation rules do not present a material credit risk to the ADI, and assets sold under such programs will continue to be entitled to capital relief. Accordingly, APRA proposes to remove any references to accounting standards in its guidance notes, effective from 1 July 2006. Specifically, AGN 120.1 will be amended to remove the explicit reference to accounting treatment in the separation criteria and these criteria will be enhanced, where appropriate, to ensure they fully reflect prudent clean sale practices. Consequently, the assessment of securitised assets for capital adequacy purposes will be de-coupled from the accounting treatment of these assets.

For purposes of measuring capital adequacy and other statistical reporting, APRA has two main options. Assets sold to securitisation vehicles could be reported to APRA on a fully consolidated basis, in line with AASB 139, with those securitised assets passing the clean sale test receiving a zero risk-weighting for capital adequacy purposes. Specific prudential measures such as impaired assets would, however, need to take into account how securitised assets are reported. Alternatively, those securitised assets that meet the clean sale test could be deconsolidated and excluded from APRA's statistical reports altogether. Whichever approach is adopted, APRA will need to collect more information about securitisation transactions potentially on a separate statistical return, covering key balance sheet, income and expense items and other prudential measures, to enable it to better understand the impact of securitisation on an institution's risk profile and for calculating changes to capital requirements under Basel II. APRA's preference is that assets that pass the clean sale test be excluded from all measures reported on existing APRA statistical returns and that selected securitisation information be reported to APRA separately.

Other APRA initiatives relevant to securitisation

APRA is undertaking three current initiatives, unrelated to IFRS, which are likely to have an impact on prudential requirements for securitisation activities.

First, the new Basel II Framework, which comes into effect from 1 January 2008, introduces a regulatory capital charge for operational risk borne by ADIs, including the operational risks associated with securitised assets. (The current ADI capital adequacy regime relevant to securitisation focuses exclusively upon credit risk.) In July 2005, APRA released a discussion paper setting out the methodology for calculating the regulatory capital charge for operational risk for ADIs adopting the standardised approach; a discussion paper on the more sophisticated Basel II approaches to operational risk will be released in coming months.

Secondly, APRA has recently undertaken a review of business practices at ADIs and the level of compliance associated with certain aspects of the clean sale rules. APRA is also examining its current prudential requirements for securitisation activities in light of international regulatory changes and market developments in Australia since these requirements were issued. Revisions to APRA's prudential standard and guidance notes will take the results of this work into account.

Finally, APRA has been considering its approach to the use of securitisation techniques by general insurers and the impact of securitisation on their capital requirements. This market is at a much earlier stage of evolution and the introduction of a prudential standard for general insurers harmonised with APS 120 would involve rule-making in advance of market practice. Instead, at this point, APRA intends to consult with general insurers before they enter into securitisation arrangements, and consider each transaction on a case-by-case basis.

General insurers can securitise assets or insurance liabilities and, internationally, securitisation of insurance liabilities has been more prevalent to date. This will require APRA to examine different aspects of securities compared with ADIs, where the focus has been only on securitisation of assets. APRA's prime concern is that any securitisation of liabilities is effective at transferring or mitigating risk, so that any possible reduced insurance capital charge is justified. Hence, the principles that underpin APRA's clean sale and separation rules will still be relevant but the details of how those principles would apply to the securitisation of liabilities need to be developed. Other issues to be considered in respect to securitisation include the general insurer's Risk Management Strategy, its Reinsurance Management Strategy and the treatment of reinsurance recoveries from losses arising on securitised liabilities.

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