

Basel 3: ***The journey begins*** Comparison of APS 330 disclosures

January 2013





Introduction

The last years have been nothing if not challenging for the banking industry as banks and regulators worked through the consequences of the GFC.

Key challenges are in particular:

- Subdued credit growth; combined with
- A regulatory focus on capital: APRA released Prudential Standards in November 2012 which put additional constraints on capital and aimed at improving both the quality of eligible Tier 1 capital and the measurement of capital requirements; and
- The introduction of new liquidity rules which aim at strengthening liquidity buffers and encouraging the longer term resilience of the banking system.

Some of these elements have flowed through to the regulatory capital reporting of the major banks for the year to 30 September 2012. This publication includes a detailed analysis of lending exposures from the major bank APS330 disclosures.

The following are the key trends highlighted from the analysis:

- **Subdued credit growth**

Balance sheet growth has significantly slowed down over the past year across all majors, with ANZ leading its peers by increasing its overall exposure by 7.5% in contrast to only 2.1% growth for NAB at the other end of the spectrum.

- Mortgage portfolios and corporate (including specialised lending) continue to be a consistent source of growth for all the major banks. While CBA and Westpac remain significantly more exposed to retail lending, and ANZ and NAB to business lending, we observed a slight movement in portfolio split by NAB towards retail.
- Strategies differ across banks on the “bank” portfolios. NAB and CBA reduced their exposures significantly (-\$12.2b and -\$4.0b respectively), while Westpac increased its bank exposure by \$4.3b. However Westpac is still holding less bank exposures than its peers.

- **Regulatory focus on capital**

All major banks except CBA have continued to grow their capital ratio.

- Tier One capital ratio for all major banks was above 10% under the Basel 2.5 rules.
- Banks are generally well capitalised and positioned to transition to the APRA Basel 3 rules. Under these rules, solvency ratios are expected to decrease due to increased capital deductions from common equity Tier 1 capital, an increase in capitalisation rates and increase in RWA. ANZ's estimated impact of those rules (excluding the liquidity reforms) is a decrease in its Tier 1 capital ratio by 1.1% (from 10.8% to 9.7%).

- **Preparing for liquidity requirements**

More liquid assets are being held in the banking books with increasing exposures towards sovereign for all banks in anticipation of the implementation of the future liquidity requirements. ANZ leads the way (+\$11.4b) and holds 10% of its exposure in the sovereign asset class.

2013 will bring a new set of challenges with a prospect of higher funding costs, slower credit growth, mostly due to general business and consumer caution, and a lower interest rate environment.

While Australia's financial sector and the condition of the real economy remain favourable by international standards, Australia's two-speed economy has been hit by a series of blows that point to an end to the mining boom and question another rate cut from the Reserve Bank of Australia (RBA).

Against this backdrop, a number of risks will need to be closely managed and in particular risks arising from a combination of high household debt and elevated house prices, reliance on offshore funding, and a highly concentrated and interconnected banking system.

Over the past year, authorities have increased their focus on those elements and have required banks to run stress tests. Results of those stress testing exercises by APRA and the IMF show that the banking system is likely to withstand severe shocks ranging from slow growth to severe macroeconomic shocks. However the IMF suggests that a higher capital threshold for the systemically important institutions may be desirable to further bolster financial system stability.



Key changes in regulatory capital for major banks

Total risk weighted assets (RWA) has increased over the last year for all of the major banks, except for NAB. This trend is mainly driven by an increase in credit risk, operational risk, and market risk, while Interest Rate in the Banking Book (IRRBB) risk has decreased due to greater embedded gains from interest rates.

RWA increased by +\$19.3b over the 12 months to September 2012 for ANZ, mainly driven by an increase in operational risk (+\$8.1b) during the past quarter, and in credit risk (+\$5.2b) and in interest rate risk in the banking book (IRRBB, +\$4.0b) throughout the year. The increase in operational risk was primarily driven by the implementation of operational risk model changes. Credit risk growth was the result of business growth in the corporate (+\$18.4b), residential mortgage (+\$16.0b) and sovereign (+\$11.4b) portfolios. This was partially offset by a risk improvement due to reduction in tenor. IRBB RWA increased over the year due to greater repricing and yield curve risk.

The drop in RWA for NAB (-\$9.8b) is driven by credit risk (-\$8.9b). This mainly results from a review of RWA business rules and in particular the classification of loans by approach and asset classes.¹ NAB's balance sheet's growth is also lower than that of its peers, with a slight decrease in its corporate portfolio (-\$0.6b) and a drop in the bank portfolio (-\$12.2b).

¹ The reclassification of the Advantaged portfolio from the standardised to the advanced approach, together with changes in securitisation treatment resulted in significant RWA decreases. These impacts were partially offset by reclassification of some commercial property loans and retail SME assets collateralised by residential mortgages.

CBA experienced a +\$10.5b RWA increase since September 2011, primarily driven by an increase in volume for corporate lending (+\$8.2b out of the +\$9.4b increase in credit RWA). Other factors that impacted CBA's credit RWA included growth in residential mortgages (+\$12.9b) and sovereign (+\$6.1b) portfolios. These increases were partly offset by a reduction in the bank portfolio (-\$4.0b) and RWA reductions due to a focus in data improvement and methodology enhancements (e.g. implementation of a new PD model for residential mortgages). The operational risk increase (+\$3.4b) reflects a more conservative assessment of their risk profiles.

RWA increased by +\$17.9b over the past year for Westpac, mainly driven by an increase in credit risk (+\$8.7b) and in operational risk (+\$7.1b). Credit risk increased as a result of a combination of business growth (residential mortgage +\$18.7b, corporate +\$8.1b, sovereign +\$4.1b) and methodology changes. The increase in operational risk is due to the implementation of a new operational risk model which places greater emphasis on low probability, high impact scenarios as well as external loss data, together with higher Australian regulatory expectations.

Figure 1: Total risk weighted assets

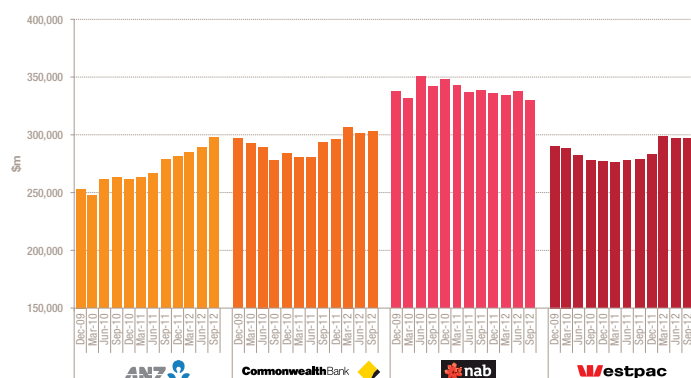


Table 1 : Total risk weighted assets (\$m)

	30 Sep 2011	30 Jun 2012	30 Sep 2012	% Change (Jun to Sep)
ANZ	280,077	290,690	299,395	3.0%
CBA	294,247	302,783	304,794	0.7%
NAB	340,918	339,695	331,071	-2.5%
Westpac	279,961	298,033	297,901	0.0%
Total	1,195,203	1,231,201	1,233,160	0.2%

Credit risk

Total credit risk RWA increased for all major banks except NAB, but at a slower pace than business growth.

- This is a result of business growth being in lower-risk portfolios (residential mortgages and sovereign), together with an overall improvement in the portfolio quality (rating migration and lower delinquencies) over the past year. However, past quarter results suggest that we might be at a turning point.
- We also observe significant measurement changes over the year, with the implementation of a new methodology to determine the probability of default (PD) for the residential mortgage portfolio for CBA and changes in business rules to classify facilities by asset class for both CBA and NAB.

Figure 2: Portfolio size

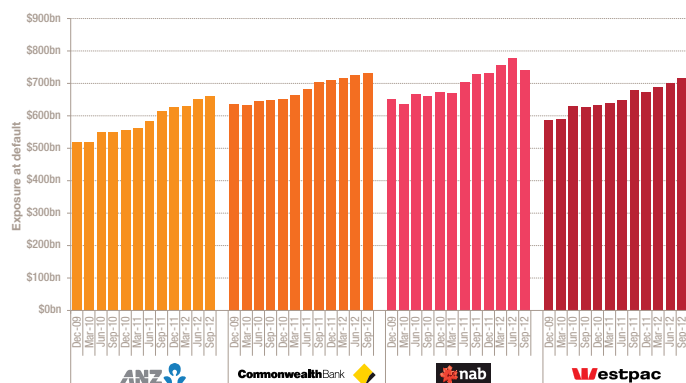


Figure 4: Portfolio size by approach and segment (AIRB/standard)

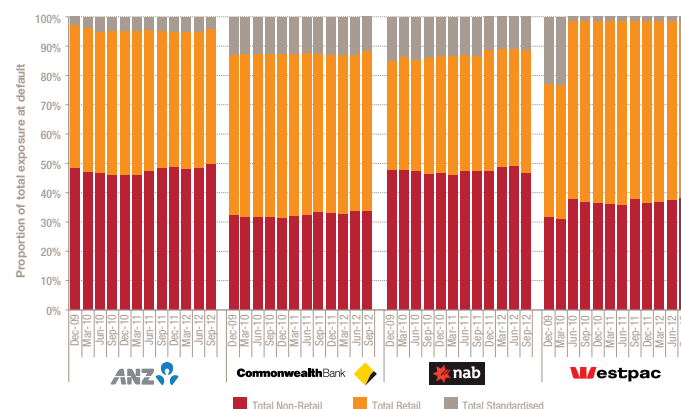


Figure 3: Portfolio absolute risk

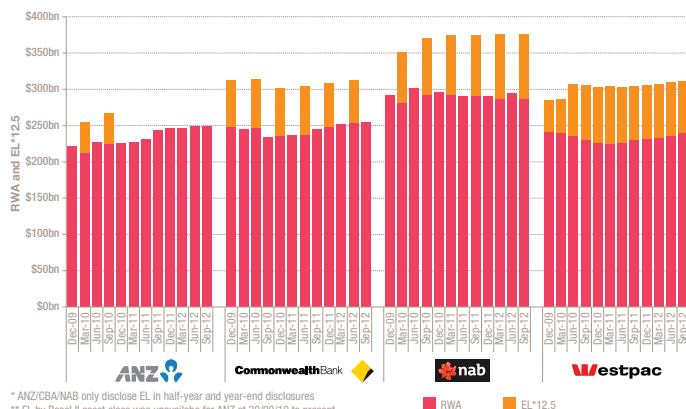
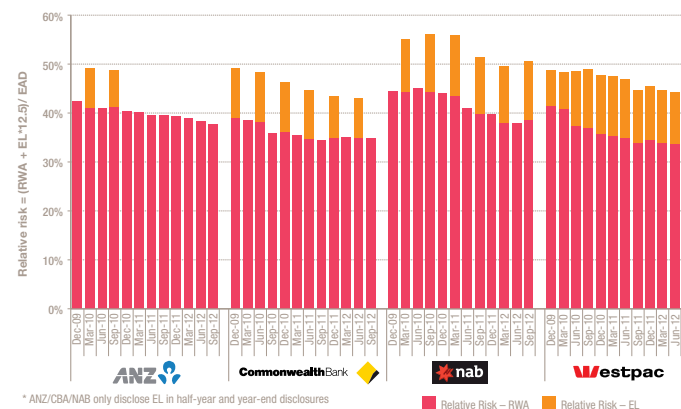


Figure 5: Portfolio relative risk



* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures

** EL by Basel II asset class was unavailable for ANZ at 30/09/10 to present

* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures

** EL by Basel II asset class was unavailable for ANZ at 30/09/09



Uncertainties around impairment

The 12 months to September 2012 have seen the overall quality of the portfolio continue to strengthen with key metrics showing signs of improvement:

- Slight decrease in impaired and defaulted assets;
While remaining at a relatively high level of stress, impaired and defaulted assets have slightly decreased across all major banks over the last year, with commercial property continuing to be overly represented. Portfolio write-offs continue to fluctuate from quarter to quarter across the major banks and there is no clearly identifiable trend. Portfolio write-offs are highly dependent on the bank's write-off review processes.
- Continued upgrades of facilities moving out of stress and back to performing;
Analysis of credit exposure by PD band for each major bank shows a general improvement with a higher proportion of exposure in lower risk bands.
- Lower seasonal delinquency peaks.
Delinquencies for registered mortgages, SME lending and credit cards have improved modestly, assisted by lower interest rates and lower unemployment.

These elements can be attributed to both tighter underwriting processes, and a general upward trend in the economy.

We are not sure that this trend has much further to run, given business conditions and newly emerging economic stresses. CBA and NAB in particular have already experienced an increase in their corporate impaired assets over the past quarter. According to Moody's, "there may be moderate and patchy pressure on asset quality, but impairments will likely remain below the sector's long-term average."

Changes in portfolio quality affect a bank's credit risk in different manners depending on the characteristics of each loan. Banks are expected in general to cover their Expected Losses (EL) on an ongoing basis. The Unexpected Loss (UL), on the contrary, relates to potentially large losses that occur rather seldomly and for which capital is held. When looking at credit risk, it is therefore important to look at both EL and RWA, as can be shown in the graphs below.

Figure 6: Portfolio quality

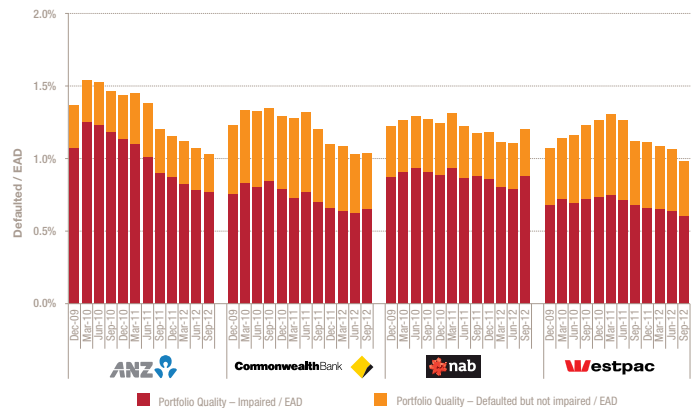


Figure 7: Portfolio write-offs

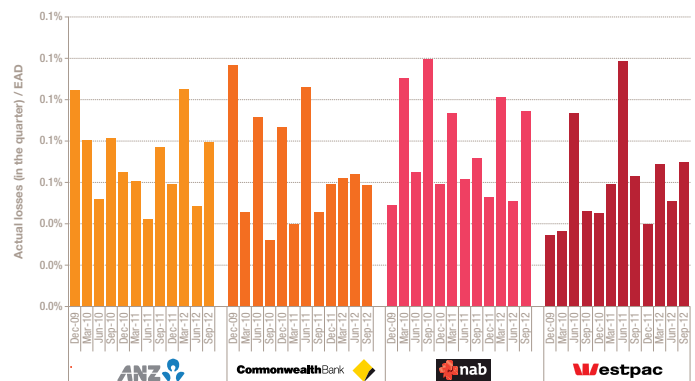


Figure 8: Actual loss and expected loss

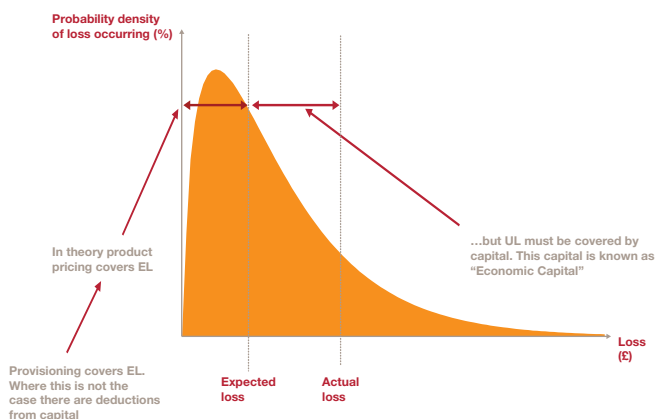
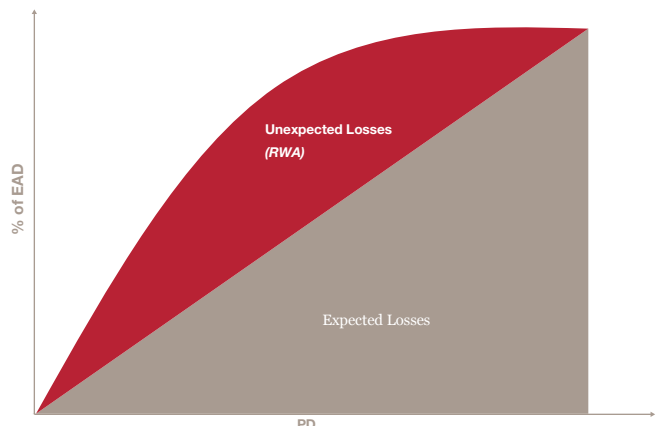


Figure 9: The RWA curve



Other risks

Market risk and operational risk have increased significantly over the past year, mainly due to regulatory requirements.

Market risk has increased by roughly 50% across all banks, due to the introduction of stressed value at risk as part of Basel 2.5.

Operational risk requirements have significantly increased for all banks, except NAB, due to a review of their risk profiles and increased regulatory requirements. Operational risk now represents 9% of the banks overall RWA (except for NAB: 7%)

There were some sizeable decreases in RWA for IRRBB (up to -\$3.7bn for CBA) mainly due to higher embedded gains from lower interest rates, with the exception of ANZ (+\$4.0bn).

Figure 10: Operational risk

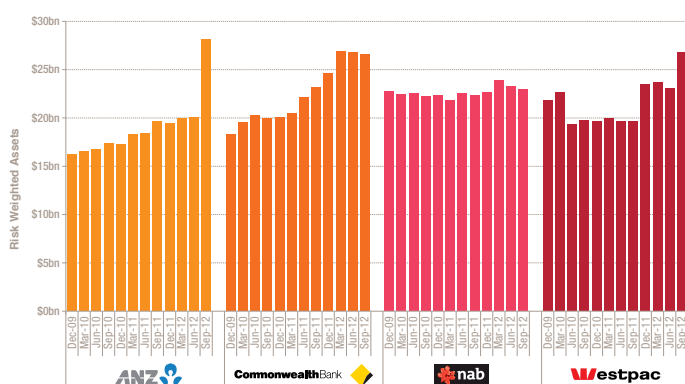


Figure 11: Interest rate risk in the banking book

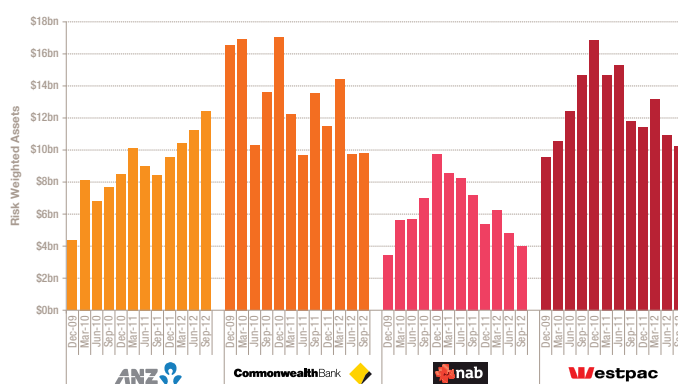
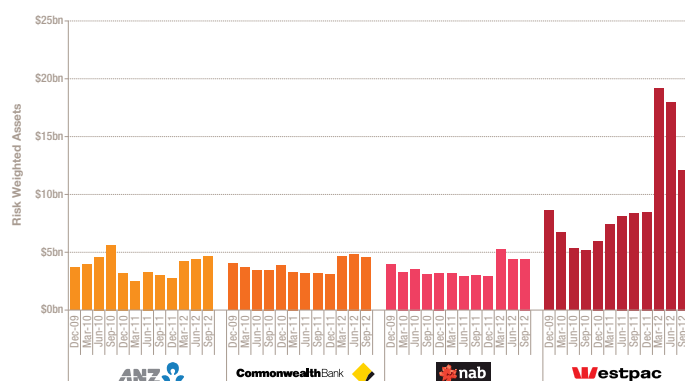


Figure 12: Market risk



Liquidity reform

On 7 January 2013 the Basel Committee on Banking Supervision (BCBS) issued a finalised standard on the Liquidity Coverage Ratio (LCR). It is envisaged that the complementary longer term ratio, the NSFR would be subject to review and, if necessary further calibration, by mid-2017.

Overall, the approach set out in the original December 2010 proposal for the LCR remains broadly similar – banks must assess the potential outflow and must maintain a stock of unencumbered High Quality Liquid Assets (HQLAs) to be able to withstand a 30-day stress scenario.

Yet, the following changes were endorsed:

- An increase in the range of eligible assets that can be held as part of the required liquidity buffer (but note that this is subject to the discretion of each national supervisor);
- Changes to the assumptions as to cash outflows and inflows ‘to reflect better experience in times of stress’;
- A revised timetable: the BCBS has decided to delay the full implementation of the measure with a transitional period until 1 January 2019 – during which the minimum level of liquidity coverage will gradually rise from 60% to 100%; and
- A clarification that it is expected that supervisors will permit the use of the liquidity buffer in times of stress i.e. banks will be allowed to use the buffer, and thus fall below the minimum ratio, in a liquidity stress scenario.

How the standards will be adopted in Australia remains to be seen. However, banks should not take too much comfort from the much-heralded relaxation of the timetable.

From an operational and systems perspective, banks still need to be in a position to report the LCR to their supervisors as of 1 January 2015 (and probably as of 1 January 2014 for most ADIs in Australia) and thus need to resolve the inevitable data issues that the new reporting requirements will reveal.

From a business perspective, banks need to make adjustments to their balance sheet in advance of the deadline (recognising that the phase-in arrangements might give more time to make adjustments to meet the 100% minimum requirement). While the inclusion of Level 2B assets (including Residential Mortgage-Backed Securities (RMBS), corporate debt securities and common equities) is generally seen as beneficial, Australian banks would have already had access to additional liquidity from RMBS through the Reserve Bank of Australia Committed Liquidity Facility (CLF). In addition, the relative scarcity of high quality corporate debt securities mean that this aspect of the relaxation is unlikely to have a material impact in the short-term.

The transitional arrangements, with the LCR starting at a minimum 60% and then increasing by 10 percentage-points a year until it reaches 100% on 1 January 2019, must be seen as what they are – provision of breathing space for banks that would find it hard to meet the full metric by 1 January 2015. However, it is simply a deferral of the eventual, revised full impact, and, as we have seen with the Basel III capital ratios, the market will be quick to expect banks to meet the full ratio in advance of the final deadline of 1 January 2019.



Appendices

Appendices

Corporate

Figure 13: Size

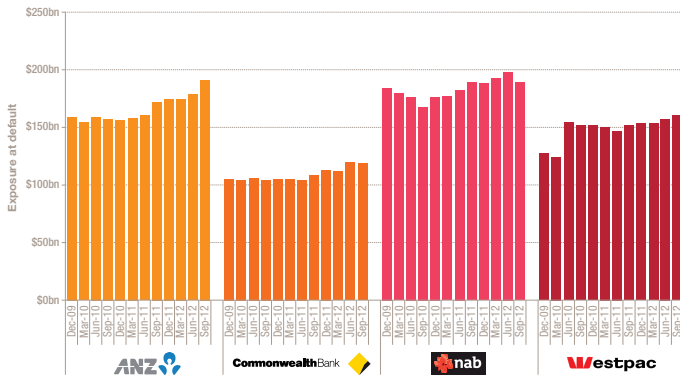


Figure 16: Proportion of EAD

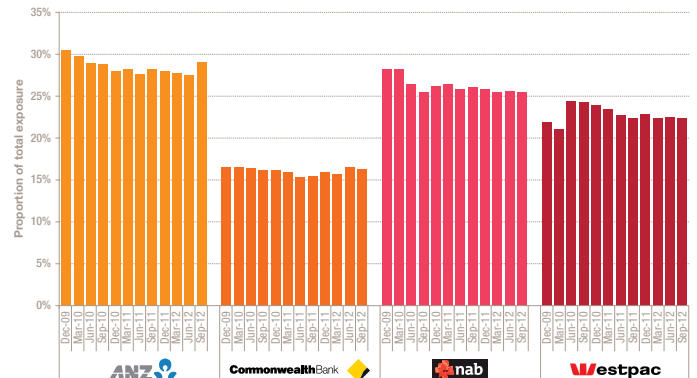


Figure 14: Absolute risk

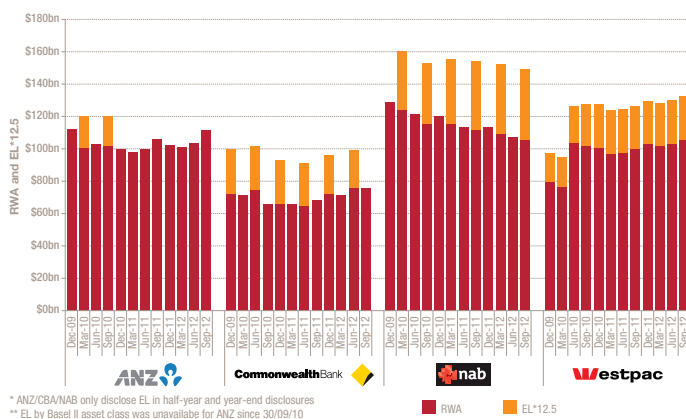


Figure 17: Relative risk

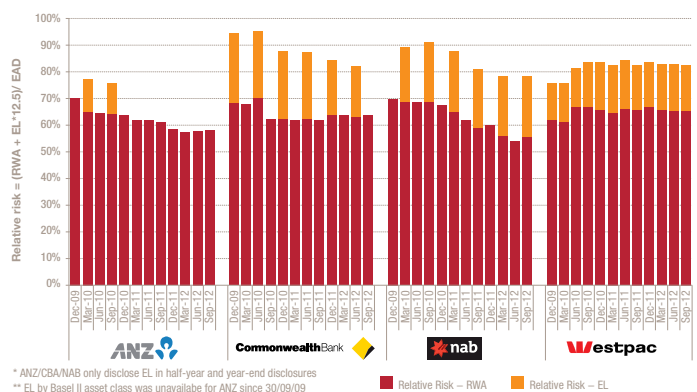


Figure 15: Quality

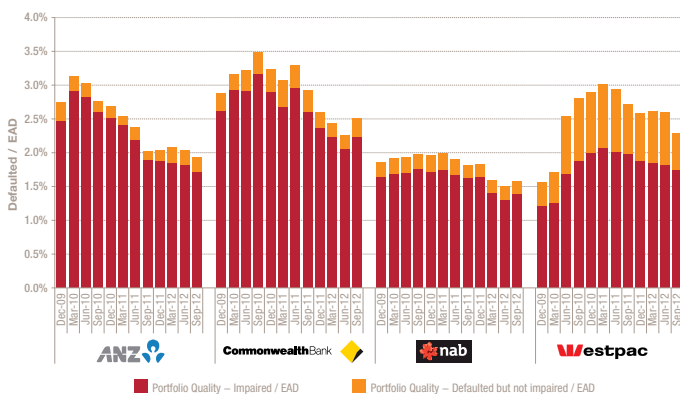
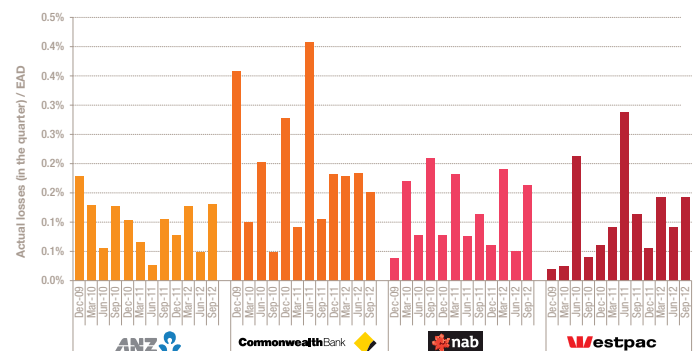


Figure 18: Write-offs



* CBA: EL, portfolio quality and write-off include Specialised Lending (SL)

Appendices

Specialised lending

Figure 19: Size

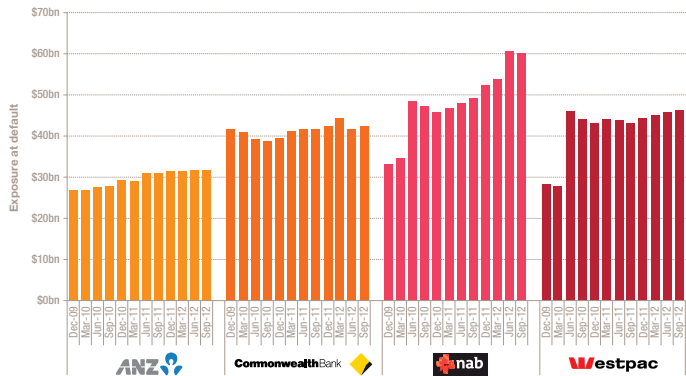
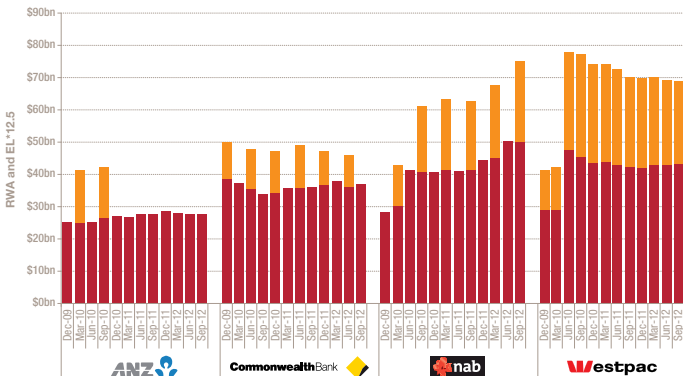
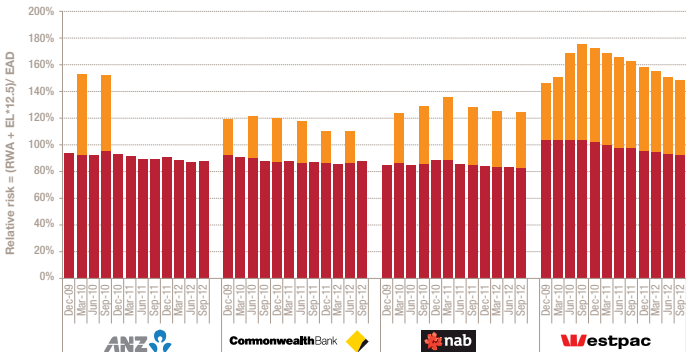


Figure 21: Absolute risk



* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures
** EL by Basel II asset class was unavailable for ANZ since 30/09/10

Figure 20: Relative risk



* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures
** EL by Basel II asset class was unavailable for ANZ since 30/09/09

Relative Risk = (RWA + EL*12.5) / EAD

Appendices

Bank

Figure 22: Size

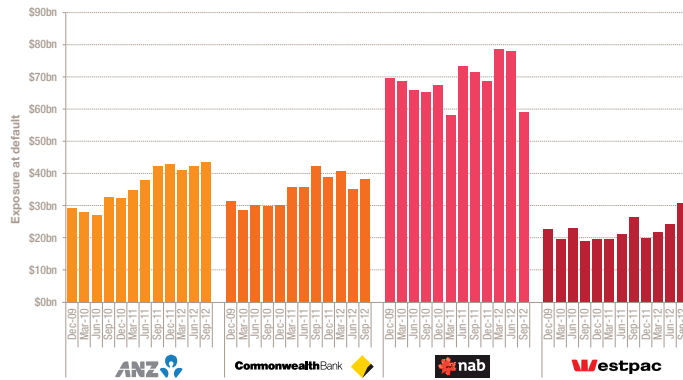


Figure 24: Absolute risk

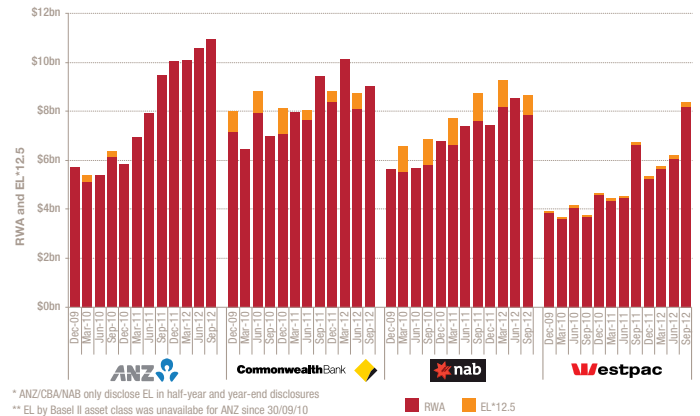
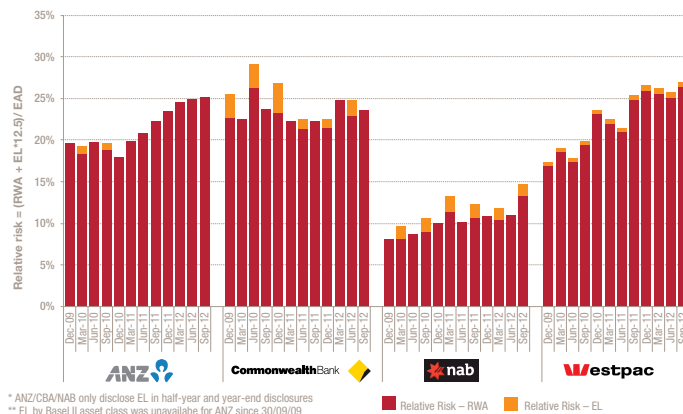


Figure 23: Relative Risk



Appendices

Sovereign

Figure 25: Size

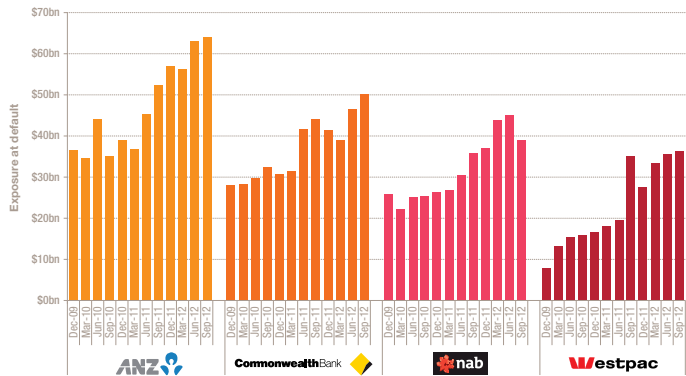
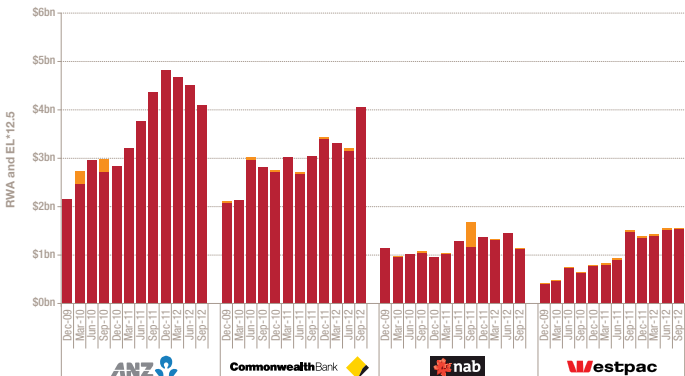


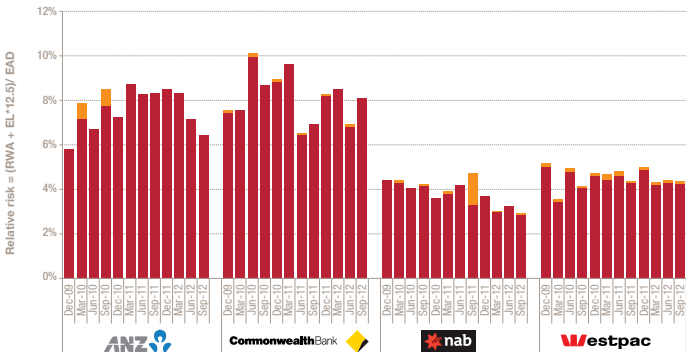
Figure 27: Absolute Risk



* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures
** EL by Basel II asset class was unavailable for ANZ since 30/09/10

■ RWA ■ EL*12.5

Figure 26: Relative Risk



* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures
** EL by Basel II asset class was unavailable for ANZ since 30/09/09

■ Relative Risk – RWA ■ Relative Risk – EL



Appendices

Residential mortgages

Figure 28: Size

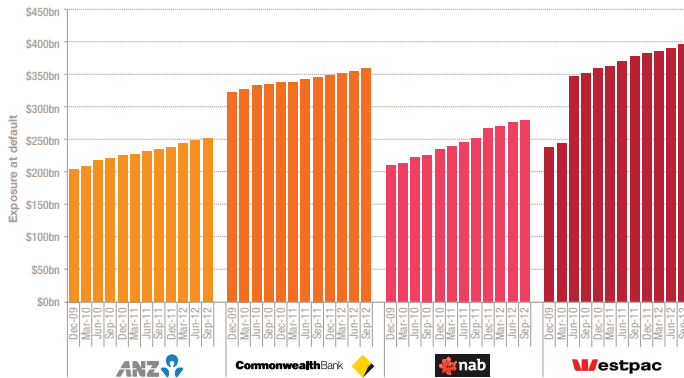


Figure 29: Proportion of EAD

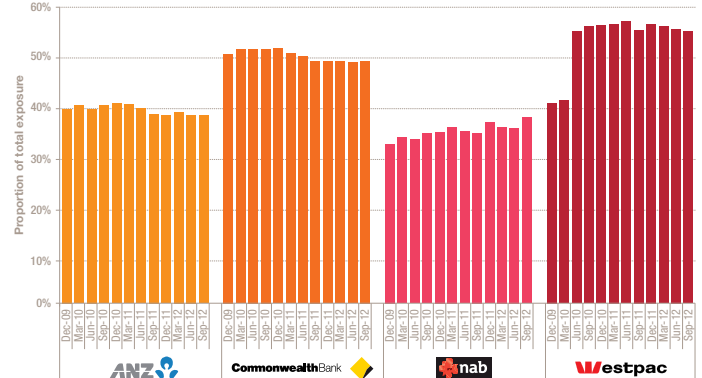
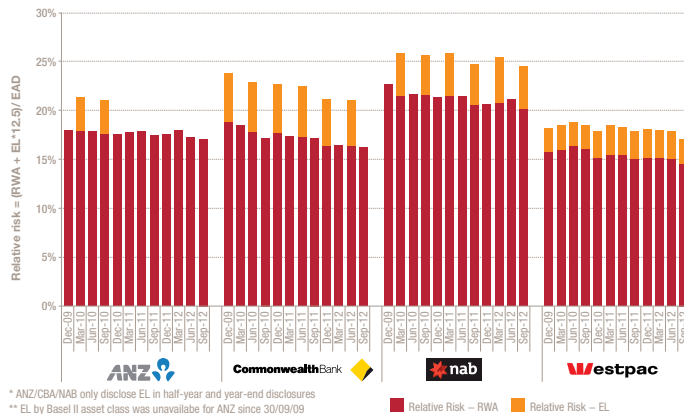
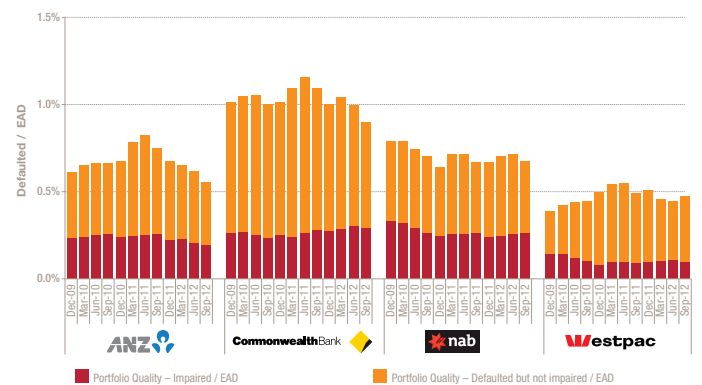


Figure 30: Relative Risk



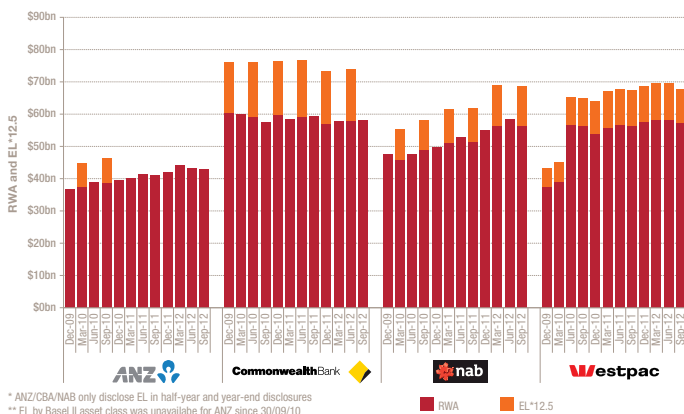
* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures
 ** EL by Basel II asset class was unavailable for ANZ since 30/09/09

Figure 31: Portfolio quality



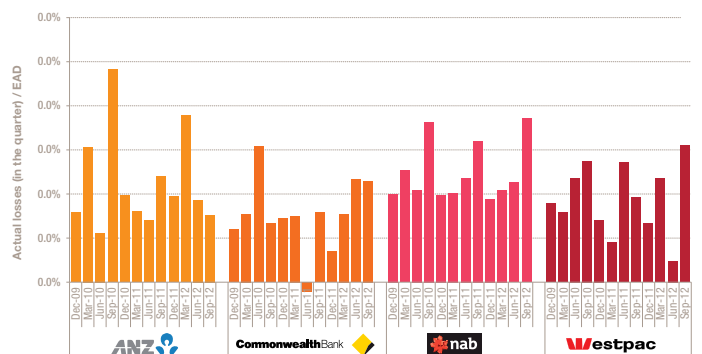
■ Portfolio Quality – Impaired / EAD
 ■ Portfolio Quality – Defaulted but not impaired / EAD

Figure 32: Absolute Risk



* ANZ/CBA/NAB only disclose EL in half-year and year-end disclosures
 ** EL by Basel II asset class was unavailable for ANZ since 30/09/10

Figure 33: Write-offs



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