December 2017

New "Basel IV" rules finalised. What is the impact in Australia?

Background

On Thursday, December 7th, the Basel Committee for Banking Supervision ("BCBS") published several papers laying out the revised requirements for the calculation of risk-weighted assets ("RWAs") and capital floors.

These papers finalise the work that BCBS has undertaken since 2012 to calibrate the Basel III framework.

The reforms, finalised on Thursday, together with earlier publications that revise the calculation of RWAs, including the revised market risk framework published in January 2016, are collectively referred to as "Basel IV" by the industry.

Key Facts

The market will be pleased to see that the announcement is not as bad as feared, and APRA has affirmed that it expects any capital increases to already be factored into their July announcement. Key facts from the Basel Release are:

- Capital Floor set at 72.5%. Therefore banks using internal models must hold at least 72.5% of the capital determined under the standard approach.
- Capital Floor set at a bank level, rather than a risk type level, which may result in capital allocation headaches within banks.
- Standard approach models to become more risk sensitive across all risk classes.
- No advanced approach for Operational Risk.
- Credit Risk Standard Approach risk weights are reduced for key sectors such as real estate.
- No major changes announced for the Fundamental Review of the Trading Book (FRTB - Market Risk).
- All changes are scheduled for one 'big bang' implementation on 1 January 2022, with the Capital floor scaling up over 5 years.

APRA's Response, and impact to Australian Banks

Simultaneous announcements by APRA and the BCBS underscore APRA's involvement in finalising the reform package, which emphasises their commitment to implementing these reforms. In our view the key messages for Australian banks are:

- APRA reaffirms its expectation that ADIs should be following strategies to increase their capital strength to exceed the unquestionably strong benchmarks by 1 January 2020.
- The 5% point reduction in standardised risk weights for residential mortgages provides a more favourable outcome for mortgage heavy Australian banks.
- On our estimates, based on a typical portfolio mix by LVR, the standalone capital floor for residential mortgages is just below the current average RW of 25% for the Majors.
- As the LVR must be calculated using the property value at origination, there is an incentive for market churn ahead of the reform timetable.

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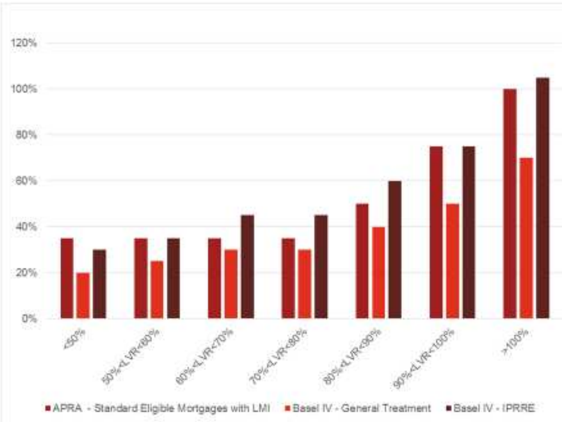
- The two “wild cards” are the portion of mortgages deemed to be Income Producing Residential Real Estate (IPRRE) and accounts that do not satisfy the operational requirements.
- IPRRE loans are broadly defined as loans for which debt servicing is “materially dependant” on cash flows generated from the property. They incur a 10% to 35% higher risk weight depending on the LVR.
- Shown below are the comparative risk weights by LVR band, showing the sharp increase for IPRE loans.



- Locally, the future capital cost has been somewhat neutralised by recent rate increases in interest only and investor loans.
- Loans that do not satisfy the operational requirements can be weighed up to 150% for IPRRE loans. As such, there could be benefit in reviewing processes and/or file standardisation ahead of the implementation timetable.
- Both issues, IPRRE and Operational Requirements, provide additional levers for APRA to pull in taming the housing market and reinforcing sound lending practices.

PwC Webinar – Friday 15 December

PwC is presenting a webinar on Friday 15 December to cover these changes and discuss impacts to Australian Banks.

Please register at www.pwc.com.au/basel-iv.html for general updates and invitations to the webinar will be sent early next week.

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