

As at this evening there are 69 working days before the implementation of the Basel 11 reforms. Hopefully, the majority of Credit Unions have, at least, turned their minds to what they have to do to comply with the reforms and are well on the way to doing so.

The quarterly return for the period ending 31 March 2008 will have to be in the new format that is consistent with the Basel approach.

Our brief is to offer as much assistance as requested and to be available to industry in the lead up to the implementation. We are pleased that the industry appreciates the urgency in understanding the Basel changes and preparing itself for implementation. We have prepared extensive training material and have welcomed an invitation from ABACUS to participate in their forums and workshops, which ABACUS has indicated will be held in the near future.

Rather than go through the entire framework, I intend to focus only on those matters that I think are relevant to this Group, what Credit Unions will have to do to comply with the requirements and where we think people should be at with 69 days to go.

At Pillar 1, the main changes that most Credit Unions will see will be to APS 110 and APS 111- the capital standards, APS 112 Credit Risk and APS 114 Operations Risk. Those Credit Unions that are involved in securitisation by way of offering facilities to securitisation vehicles will have to be aware of APS 120. All Credit Unions will have to comply with the new disclosure requirements of APS 330.

There are new reporting forms that incorporate the changes that will result from the implementation of the Basel reforms.

The role of supervisory review has been formalised as part of Pillar Two changes. While there will be no substantial change in the relationship between APRA and its supervised entities, that relationship has been codified as part of the Basel framework.

Pillar 3 introduces more rigorous disclosure requirements.

The draft prudential standards have been issued a number of times and have been subject to extensive industry consultation. ABACUS has made submissions on behalf of its members. The consultation period for the final drafts closed at the beginning of this month and we are working through these submissions at the moment. This may result in some further fine tuning to the Standards. The format of the Standards is being revised at the moment to remove some of the text into Prudential Practice Guides, to make them more user friendly especially for ADIs which are not subject to large parts of the standard. However, there are unlikely to be any significant changes to policy decisions at this stage, certainly not so as to warrant institutions delaying any progress towards implementation.

The new reporting forms were issued to industry for consultation at the end of August and the consultation period closes at the end of this month. The forms as they stand reflect the requirements of the final drafts of the standards. It is therefore unlikely that there will be many material changes to the forms as a result of the consultations. An introduction to the forms is part of the assistance that has

been offered to industry, but it will not substitute for your staff having a detailed understanding of the requirements and seeking direct clarification where needed.

APS 112

As part of the Pillar 1 minimum capital requirements, there are additional and revised provisions relating to credit risk. A lot of the changes that relate to linking risk weights to External Credit Assessments will not apply to smaller ADIS that do not have exposures with rated counterparties. The more relevant changes that relate to this audience are:

Changes in the treatment of residential mortgage secured loans

Changes in exposures to other ADIs

Changes to the treatment of certain types of delinquent mortgage loans

Residential mortgages at this stage are risk weighted at 100%; or at 50% where the qualifying mortgage requirements are met. APRA's Basel 2 approach extends the range of circumstances under which loans secured by "eligible residential mortgage" qualify for concessional risk weighting treatment. There are now four risk weighting bands for Eligible Residential Mortgages secured loans set at 100%, 75%, 50% and 35% depending on the combination of each loan's LVR and whether it is a standard or non-standard loan or whether or not it is covered by acceptable LMI. To comply with this requirement, Credit Unions will need to be able to classify their exposures into the relevant buckets. APRA expects that Credit Unions will be well advanced in doing this classification and not merely waiting for system changes to be implemented by their service providers.

The standard draws a distinction between standard loans and non-standard loans. The distinction is essentially one of whether the ADI is following its own credit policies. Where an ADI has good policies covering assessment, verification of borrower information, security and valuation, any loan made that complies with the policy is considered to be standard and is eligible for the appropriate risk weight. Loans outside policy are not eligible. The so-called low docs that have been popular over the last few years with some lenders are of course non-standard. Credit Unions should ensure that they only make loans that comply with Board approved policies if they want to avail themselves of the concessional rate.

Currently, all exposures to Australian ADIs are risk weighted at 20%. APRA's Basel 2 proposals require that these exposures to ADIs be risk weighted in accordance with the external credit rating for the ADI. Unrated ADI exposures attract a default risk weight of 50%. However, short term exposures to ADIs with an original maturity of three months or less retain their current risk weight even if they are unrated. Credit Unions need to be aware, with deposit placements with other Credit Unions, risk weights differ depending on the original maturity. CUSCAL is a rated institution and as such the current risk weighting will be unchanged in the post Basel world.

Under Basel 2, the unsecured portion of any claim other than claims secured by eligible residential mortgages that are past due 90 days or impaired will be treated differently for risk weighting purposes. Where the specific provisions are no less than 20% of the outstanding amount, the risk weight will be 100%. Where specific provisions are less than 20% of the outstanding amount, the risk weight will be 150%. In the case of loans secured by eligible mortgages, with no acceptable LMI, 100% and where there is acceptable LMI in place the original risk weighting

remains. However once the aggregate exposure on account of impaired loans to the LMI reaches the Credit Union's general large exposure limit, the risk weighting becomes 100%. Credit Unions should now be reviewing their delinquency processes to ensure that they include appropriate mechanisms for identifying delinquent exposures that may require a modified risk weighting treatment.

APS 114

To date, Credit Unions have been required to recognise operational risk as part of their overall risk management framework. This requirement continues and the critical importance of controlling operational risk has been given additional gravitas in the Basel 2 framework by the introduction of a new specific capital charge for operational risk.

APRA recognises that operational risk can be mapped to three main business areas:

- Retail banking business
- Commercial banking business
- All other business activities

Consistent with the Basel framework, APRA uses different "proxy indicators" to estimate the level of operational risk in each of these three business areas. For the retail banking and commercial banking areas of business, total gross loans is the relevant proxy indicator on which the operational risk charge is based. The loans indicator will need to be apportioned between retail banking and commercial banking as appropriate. The respective loan bases are scaled by a factor of 3.5% to represent an income approximation. The operational risk charge is then calculated at 12% in the case of retail banking and 15% in the case of commercial banking.

For the all other activity areas of business, the operational risk charge is based on the level of gross income. This excludes income that would normally map to the retail banking or commercial areas of business. The operational risk charge of the all other areas of business component is 18% of the adjusted gross income.

The total operational risk charge is the sum of the three.

Credit Unions need to ensure that they have appropriate processes in place to map their activities to the three identified business areas in order to calculate the operational risk charge.

Pillar 2

I said in my introductory remarks that the relationship of institutions with their supervisors has been formalised in the framework. APRA released a discussion paper detailing its proposed approach to Pillar 2 implementation earlier this month. One of the key features of the approach is to require ADIs to implement a Internal Capital Adequacy Assessment Process.

The ICAAP should cover the ADI's treatment of credit risk, operational risk and market risk to the extent that it is relevant. These are the risks covered in Pillar 1 of the Basel framework. The risks identified in Pillar 1 are not exhaustive and to the extent relevant, ADI must consider any other risks. Examples of this are

- Credit Concentration

- Interest rate risk arising from the mismatch of maturities of assets and liabilities
- Strategic risk
- Contagion and reputation risk

Credit Unions will be expected to factor into their ICAAPs very adjustments to their core risk profile. These can include stress testing adjustments, planned business growth and risk diversification benefits.

ICAAPS are expected to consider the buffer of capital over the minimum, should allow for fluctuations in earnings and provide contingency plans for access to additional capital if required.

The maintenance and periodic review is the main change to APS 110 as far as credit unions are concerned. There is no reason why credit unions should not be on the way to preparing this.

The other noteworthy feature is the new Prudential Capital Requirement. Consistent with its existing processes for determining capital adequacy, APRA is proposing to set a prudential capital requirement for each ADI which must be met at all times. Subject to the minimum of 8% established in the framework, these ratios will be set at a level proportional to each ADI's risk profile. APRA will use its existing rating tool, PAIRS to assist in the process. The better the ADI's ICAAP, the easier and less painful that process will be for both parties.

Pillar three

The Basel II framework refers to “market discipline” whereas APRA in implementing Pillar 3 of the Basel II (through APS 330) refers to “market disclosure”

“Disclosure enhances transparency. Transparency is important because it enables informed decision making and therefore promotes market discipline. Informed decision making is crucial to efficient capital market and also contributes to financial stability. Therefore, disclosure promotes financial stability.”

APS 330 contains details of the kinds of disclosures that need to be made. These disclosures must be made quarterly within 40 days of the close of the period to which they relate. They must be on the website in full in one location unless the ADI does not have a website APRA can approve an alternative location or medium.

Matters that must be disclosed are details of the ADI capital structure i.e. breakdown of capital calculations, capital adequacy capital requirement for each component - credit risk, operational risks etc, total and tier one ratios. There is an additional disclosure requirement for credit risk. There is a standard format in which these disclosures must be made and this can be found in APS 330.