



## **Prudential Standard APS 110**

### **Capital Adequacy**

#### **Objective and key requirements of this Prudential Standard**

This Prudential Standard aims to ensure that ADIs maintain adequate capital to support the risks associated with their activities on both a stand-alone and group basis.

This Prudential Standard outlines the overall framework adopted by APRA for assessing an ADI's capital adequacy.

## Authority and application

1. This Prudential Standard, made under section 11AF of the *Banking Act 1959* (**the Act**), applies to all authorised deposit-taking institutions (**ADIs**) authorised under the Act. The *Guidance Notes AGN 110.1 Conglomerate Group (AGN 110.1)*, *AGN 110.2 Non-Consolidated Subsidiaries (AGN 110.2)*, *AGN 110.3 Level 3 Assessment (AGN 110.3)*, *AGN 110.4 Risk-based Capital Adequacy Framework (AGN 110.4)*, *AGN 110.5 Higher Minimum Ratios (AGN 110.5)* and *AGN 110.6 Reductions in Capital (AGN 110.6)* form part of this Prudential Standard.
2. Foreign ADIs (which have the same interpretation as in Division 1B of the Act) operating through branches in Australia are not subject to this Prudential Standard, *Prudential Standards APS 111 Capital Adequacy: Measurement of Capital (APS 111)*, *APS 112 Capital Adequacy: Credit Risk (APS 112)* and *APS 113 Capital Adequacy: Market Risk (APS 113)*. They must, however, be subject to comparable capital adequacy standards in their home country.

## Responsibility for capital management

3. Capital is the cornerstone of an ADI's financial strength. It supports an ADI's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enabling the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved. The Board of an ADI has the duty to ensure that the ADI maintains an appropriate level of capital commensurate with the level and extent of risks to which the ADI is exposed from its activities. To this end, the ADI must:
  - (a) have adequate systems and procedures in place to identify, measure, monitor and manage the risks arising from its activities on a continuous basis to ensure that capital is held at a level consistent with the ADI's risk profile; and
  - (b) maintain and implement a capital management plan, consistent with the overall business plan, for managing its capital levels on an ongoing basis. Essentially, the plan must set out:
    - (i) the ADI's strategy for maintaining capital resources over time, for example, by outlining its capital needs for supporting the degree of risks involved in the ADI's activities, how the required level of capital is to be met, as well as the means available for sourcing additional capital where required; and
    - (ii) actions and procedures for monitoring the ADI's compliance with minimum regulatory capital adequacy requirements, including the setting of trigger ratios to alert management of, and avert, potential breaches to the minimum capital ratios required by APRA.
4. Where an ADI is a member of a conglomerate group (refer AGN 110.1), associations with other members in the group may expose the ADI to the

potential of contagion risk – the possibility that difficulties encountered by individual entities in the group might be transmitted to the ADI (refer *Prudential Standard APS 222 Associations with Related Entities*). In determining stand-alone capital adequacy, the Board of the ADI must have regard to:

- (a) group risks posed by other members in the group to the ADI;
  - (b) obligations (direct or indirect) arising from associations with group entities which might give rise to a call on the capital of the ADI; and
  - (c) the ability to readily extract capital from other members in the group should the need to recapitalise the ADI arise (this would include consideration of the integration of business within the group, the importance of subsidiaries to the group, the impact of taxation, regulatory requirements and other factors on the ability to realise investments in, or transfer surplus capital from, subsidiaries).
5. Aside from maintaining adequate capital on a stand-alone basis, ADIs that head a conglomerate group (refer AGN 110.1) must also satisfy APRA that the group as a whole has sufficient capital consistent with the group's risk profile.<sup>1</sup> To this end, the Board of an ADI that heads a conglomerate group should:
- (a) establish policies on group capital adequacy (which should have regard to the type and distribution of capital resources held by the group) and implement a group capital management plan (with coverage similar to those outlined in paragraph 3(b) above) to ensure that the group overall is adequately capitalised to cover the risks faced by the group and to meet regulatory, market and strategic needs;
  - (b) ensure that appropriate systems and adequate procedures are in place to identify, assess, measure and monitor group risks on a continuous basis; and
  - (c) ensure that the group has sufficient capital freely available to meet unexpected losses and adverse shocks impacting on the group.

### **Measurement of capital adequacy**

6. To ensure that ADIs are adequately capitalised on both a stand-alone and group basis, APRA adopts a tiered approach to the measurement of an ADI's capital adequacy by assessing the ADI's financial strength at three levels (refer illustrative diagram in the Attachment):
- (a) Level 1 – the ADI on a stand-alone basis;

---

<sup>1</sup> Where an ADI forms part of a conglomerate group headed by an authorised non-operating holding company, paragraph 5 applies to the ADI and its subsidiaries.

- (b) Level 2 – the consolidated banking group i.e. the ADI and all its subsidiaries other than non-consolidated subsidiaries (refer AGN 110.2); and
  - (c) Level 3 – the conglomerate group at the widest level.
7. Level 1 and Level 2 assessments are applicable to all ADIs. Level 3 assessment applies only to ADIs prescribed by APRA (refer AGN 110.3).
8. Measurement of an ADI's capital adequacy at each of the above three levels is based on:
- (a) Level 1 & Level 2 – a risk-based capital adequacy framework based on the Basel Capital Accord (refer AGN 110.4); and
  - (b) Level 3 – the methodology agreed with APRA (refer AGN 110.3).

### **Minimum capital adequacy requirements**

9. An ADI must, at a minimum, maintain a risk-based capital ratio (refer AGN 110.4) of 8 per cent at all times under Level 1 and Level 2. At least half of the ratio must take the form of Tier 1 capital (refer APS 111) i.e. a minimum Tier 1 capital ratio of 4 per cent must be maintained. Where considered appropriate, APRA may require an ADI to maintain a minimum capital ratio above 8 per cent (at least half of the ratio must take the form of Tier 1 capital) at Level 1 and Level 2 (refer AGN 110.5). APRA expects all ADIs, as part of their capital management plans (refer paragraphs 3(b) and 5(a) above), to target and maintain Level 1 and Level 2 capital ratios (both Tier 1 and total) above regulatory minimums.
10. ADIs subject to Level 3 capital adequacy assessment must meet the minimum group-wide capital adequacy benchmarks agreed with APRA on a continuous basis. APRA may impose additional or higher Level 1 and/or Level 2 capital requirements on an ADI in a conglomerate group where it is not satisfied with the methodology for measuring the group's capital adequacy at Level 3 (refer AGN 110.3).

### **Notification requirements**

11. An ADI must inform APRA immediately of:
- (a) any breach of the minimum capital adequacy requirements under paragraphs 9 and 10 and any potential breach of these requirements (e.g. breaches of trigger ratios), including remedial actions taken/planned to deal with the problem; and
  - (b) any concerns it has about its capital adequacy (whether at Level 1, 2 or 3), along with proposed measures to address these concerns.

### **Reductions in capital**

12. Where an ADI proposes any reduction in its capital (whether at Level 1, 2 or 3), it must obtain APRA's prior written consent (refer AGN 110.6).

### **Reporting**

13. An ADI must provide APRA each quarter (or more frequently if required by APRA) with information on its Level 1 and Level 2 capital adequacy in a form to be determined by APRA from time to time.
14. ADIs subject to Level 3 capital adequacy assessment must provide APRA each quarter (or more frequently if required by APRA) with the group's capital adequacy reports in a form agreed with APRA.

## Attachment

### Application of framework to a simple corporate structure

Level 1 – An ADI assessed on a stand-alone basis

Level 2 – An ADI and all its subsidiary entities (other than non-consolidated subsidiaries) assessed on a consolidated banking group basis

Level 3 – Entire group assessed

