



Prudential Standard APS 114

Capital Adequacy: Standardised Approach to Operational Risk

Objectives and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that an authorised deposit-taking institution holds sufficient regulatory capital against operational risk exposures.

The key requirements of this Prudential Standard are:

- an authorised deposit-taking institution must divide its activities into three areas of business: retail banking, commercial banking and all other activity;
- different operational risk capital requirements apply to each of the three areas of business; and
- the total capital requirement for operational risk is the sum of the capital requirements calculated for each of the three areas of business.

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Authority

1. This Prudential Standard is made under section 11AF of *the Banking Act 1959* (**Banking Act**).

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**) with the exception of :
 - (a) foreign ADIs within the meaning of subsection 5(1) of the Banking Act; and
 - (b) ADIs that have approval from APRA to use an advanced measurement approach to operational risk under *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk*.
3. A reference to an ADI in this Prudential Standard shall be taken as a reference to:
 - (a) an ADI on a **Level 1** basis; and
 - (b) a group of which an ADI is a member on a **Level 2** basis.

Level 1 and Level 2 have the meaning in *Prudential Standard APS 110 Capital Adequacy* (**APS 110**).

Where an ADI to which this Prudential Standard applies is a subsidiary of an authorised non-operating holding company (**authorised NOHC**), the authorised NOHC must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable.

Scope

4. This Prudential Standard applies to all operations and activities of an ADI.

Definitions

5. The following definitions are used in this Prudential Standard:
 - (a) **adjusted gross income** - adjusted gross income is equal to total operating income from continuing operations excluding certain income items and excluding items for which operational risk regulatory capital is separately calculated by this Prudential Standard;
 - (b) **corporate finance activities** - including underwriting and any holdings of equity or debt arising from underwriting, arranging, facilitation, and management activities such as those associated with securitisation, mergers and acquisitions or privatisations and syndication activities that are undertaken, predominantly, with the intention of earning a fee. Also

included in corporate finance are longer term positions in equities that are held for strategic reasons and holdings in equity instruments, or in instruments that exhibit characteristics that are more like equity than debt, that arise as a consequence of loan restructurings;

- (c) **gross income** - total operating income from continuing operations;
- (d) **operational risk** - the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk¹ but excludes strategic and reputational risks; and
- (e) **operational risk regulatory capital (ORRC)** - the regulatory capital that an ADI is required to hold against its exposure to operational risk in accordance with this Prudential Standard.

Key principles

- 6. For regulatory capital purposes, an ADI must divide its business activities into three areas of business:
 - (a) **retail banking**;
 - (b) **commercial banking**; and
 - (c) **all other activity**.
- 7. An ADI's ORRC for the retail and commercial banking areas of business must be determined using a proportion of the ADI's total gross outstanding loans and advances as an indicator of each area's operational risk exposure. The ORRC for the all other activity area is determined by using gross income, adjusted to exclude income primarily relating to retail banking and commercial banking (**adjusted gross income**).

Retail and commercial banking areas

- 8. For the purposes of paragraph 7, an ADI's **total gross outstanding loans and advances** is defined as the total on-balance sheet exposure to the following items, as reported in the ADI's regulatory reporting returns provided to APRA under section 13 of the *Financial Sector (Collection of Data) Act 2001*:

Retail banking

- (a) cash holdings of notes and coins; and
- (b) loans to households.

¹ Legal risk includes, but is not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions as well as ordinary damages in civil litigation, related legal costs and private settlements.

Commercial banking

- (a) all deposits and amounts due from financial institutions;
 - (b) subject to paragraph 10, securities held in the banking book; and
 - (c) commercial lending.
9. An ADI that has funded positions with respect to corporate finance activities, must exclude those positions for the purpose of measuring total gross outstanding loans and advances for the commercial banking area of business. In addition, the balances of loans and advances that are excluded from risk-weighted assets under *Prudential Standard APS 120 Securitisation* must also be excluded from total gross outstanding loans and advances for the retail banking and commercial banking areas of business.
10. An ADI must, in calculating its total gross outstanding loans and advances within the commercial banking area of business, include the gross book value of securities² held in the banking book, excluding those arising from the ADI's involvement in corporate finance related activities and those that are deducted from capital (refer to *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*).

All other activity area

11. An ADI must, as an indicator of the operational risk exposure arising from all other activity, determine the capital requirement for that activity using adjusted gross income. Adjusted gross income may exclude irregular items but the amount must include income (including net interest income and servicing activities) from the ADI's involvement in securitisation, trading³ and corporate finance activities. In the absence of any adjustments, adjusted gross income will equate to total operating income from continuing operations.
12. The ADI must be able to demonstrate to APRA that the ORRC for the retail or commercial banking areas of business adequately captures the operational risks associated with the activities to which these items relate.

Calculation of operational risk regulatory capital

13. An ADI's total ORRC must equal the sum of the average results for the areas of retail banking, commercial banking and all other activity as set out in paragraph 14 of this Prudential Standard. The component formulae are detailed in paragraphs 16 to 19.

² A security for the purposes of this Prudential Standard includes all debt securities held in the banking book.

³ For trading activities, net income includes profits and losses on instruments held for trading purposes, net of funding costs, plus fees from wholesale broking.

14. The total ORRC is calculated as follows:

$$K_{SA} = \frac{\sum_{t=1}^6 (0.12 \times m \times LAR_t)}{6} + \frac{\sum_{t=1}^6 (0.15 \times m \times LAC_t)}{6} + \frac{\sum_{t=1}^6 \max [(0.18 \times AGI_t), 0]}{3}$$

where:

K_{SA} = the total operational risk regulatory capital under the standardised approach to operational risk

m = a fixed scaling factor of 0.035

LAR_t = total gross outstanding loans and advances (as defined in paragraphs 8 and 9) for the retail banking area of business measured at the end of each financial year and half-year of the ADI

LAC_t = total gross outstanding loans and advances (as defined in paragraphs 8, 9 and 10) for the commercial banking area of business measured at the end of each financial year and half-year of the ADI

AGI_t = adjusted gross income earned over a six month period at the end of each financial year and half-year of the ADI

t = half-yearly observation period (at the end of each financial year and half-year of the ADI)

15. An ADI must multiply K_{SA} by 12.5 in order to convert the operational risk capital requirement to a risk-weighted asset equivalent (refer to paragraph 5 of Attachment D to APS 110).

Retail banking area

16. An ADI must calculate its ORRC for the retail banking area of business by:
- (a) taking the last six consecutive half-yearly balances of total gross outstanding loans and advances for the retail banking area of business;
 - (b) multiplying 3.5 per cent of total gross outstanding loans and advances at each observation point, by a factor of 12 per cent, to produce a result in respect of each observation; and
 - (c) determining an average half-yearly result.

Commercial banking area

17. For the commercial banking area of business, an ADI must calculate its ORRC by:
 - (a) taking the last six consecutive half-yearly balances of total gross outstanding loans and advances for the commercial banking area of business;
 - (b) multiplying 3.5 per cent of total gross outstanding loans and advances at each observation point, by a factor of 15 per cent, to produce a result in respect of each observation; and
 - (c) determining an average half-yearly result.

All other activity area

18. The ORRC for an ADI's all other activity area of business must be calculated by:
 - (a) taking the last six consecutive half-yearly amounts of adjusted gross income earned over a six month period;
 - (b) multiplying adjusted gross income at each observation point by a factor of 18 per cent to produce a result in respect of each observation; and
 - (c) determining an average full-year result.
19. An ADI must, when calculating the three-year average for the all other activity area of business, set an observation to zero and include that zero observation in the numerator of the formula detailed in paragraph 14 if, for any given observation, the ADI's adjusted gross income is negative.

Financial statements

20. An ADI must reconcile, on a timely basis, the calculations set out in paragraphs 16 to 19 with its audited year-end financial statements and, where available, its half-yearly financial statements. The ADI may, with APRA's prior written approval, use business estimates or forecasts when actual balances are not available (e.g. in the case of an ADI in its early years of operation). In the event of a merger, aggregated balances must be used unless otherwise agreed to by APRA.