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Prudential Standard APS 114

Capital Adequacy: Standardised Approach to Operational Risk

Objective 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 include:

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

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1. This Prudential Standard is made under paragraphs 11AF(1)(c) and 11AF(1AA)(b) 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) those 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 (or other ADIs) in this Prudential Standard shall be taken as a reference to:
 - (a) an ADI (or ADIs) on a **Level 1** basis; and
 - (b) an ADI (or ADIs) on a consolidated banking group **Level 2** basis.

Further details on how this Prudential Standard applies on a Level 1 and Level 2 basis are set out in draft¹ *Prudential Standard APS 110 Capital Adequacy* (**APS 110**).

4. An ADI to which this Prudential Standard applies must comply with the standardised approach to operational risk on a Level 1 basis and, where the ADI is a member of a consolidated banking group, on a Level 2 basis.

Definition

5. **Operational risk** is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk² but excludes strategic and reputational risk.

Risk management framework for operational risk

6. An ADI is required to have in place a comprehensive risk management framework for operational risk. *Prudential Standard APS XXX* sets out a

¹ All references to draft prudential standards in this Prudential Standard are references to the versions that are intended to take effect from 1 January 2008.

² Legal risk includes, but is not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions as well as private settlements.

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number of qualitative requirements for managing operational risk which all ADIs must meet.³

Areas of business

7. In the standardised approach to operational risk, an ADI's activities must be divided into three areas of business:
 - (a) **retail banking;**
 - (b) **commercial banking;** and
 - (c) **all other activity.**
8. The operational risk regulatory capital requirements for the retail banking and commercial banking areas of business must be determined using a proportion of an ADI's total gross outstanding loans and advances as an indicator of each area's operational risk exposure.
9. For the purposes of paragraph 8, 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.

Commercial banking

- (a) all deposits and amounts due from financial institutions;
 - (b) subject to paragraph 11, securities held in the banking book; and
 - (c) commercial lending.
10. An ADI that has funded positions with respect to corporate finance activities,⁴ 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-

³ APRA intends to release a draft ADI risk management standard for comment later in 2007.

⁴ For the purposes of this Prudential Standard, corporate finance activities are those activities undertaken by an ADI that are motivated, for the most part, by the generation of non-interest fee-based income. In line with this, corporate finance includes underwriting and any holdings of equity or debt arising from that underwriting, arranging/facilitation/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.

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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.

11. 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 securities⁵ 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 pursuant to draft⁶ *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*.
12. An ADI must, as an indicator of the operational risk exposure arising from all other areas of business, determine the operational risk regulatory capital requirement for the all other activity area of business using gross income, adjusted to exclude income primarily relating to retail banking and commercial banking (**adjusted gross income**).
13. An ADI must, for capital adequacy purposes, calculate adjusted gross income as follows:

Adjusted gross income equals:

- (a) profit (loss) before tax and minority interest from continuing operations
- less*
- (b) net interest income from total gross outstanding loans and advances and securities included in the retail banking and commercial banking areas of business;
 - (c) fee income from automated teller machine networks;
 - (d) fee income from retail and commercial transaction accounts;
 - (e) fee income from total gross outstanding loans and advances included in the retail banking and commercial banking areas of business (e.g. loan establishment fees, administration fees and penalty fees);
 - (f) income from insurance recoveries; and
 - (g) realised profit or losses from the sale of banking book items
- plus*
- (h) bad and doubtful debt charges (net of recoveries); and
 - (i) operating expenses.⁷

⁵ A security for the purposes of this Prudential Standard includes all debt securities held in the banking book.

⁶ Refer to footnote 1.

⁷ Fees paid by the ADI to external service providers must be included in operating expenses.

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14. An ADI may, with APRA's prior written approval, exclude items not listed in paragraph 13 to calculate its adjusted gross income. To be eligible for approval in respect of an item, that item must clearly relate primarily to retail banking or commercial banking activities. The ADI must be able to demonstrate to APRA that the operational risk regulatory capital requirement for the retail banking or commercial banking areas of business adequately captures the operational risks associated with the activities to which these items relate.
15. An ADI must include, in the all other activity area of business, income (including net interest income) from its involvement in securitisation (including servicing), trading⁸ and corporate finance activities.

Calculation of regulatory capital requirement

16. The operational risk regulatory capital requirement for the retail banking area of business must be calculated 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 result.
17. The operational risk regulatory capital requirement for the commercial banking area of business must be calculated 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 result.
18. The operational risk regulatory capital requirement for the 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.

⁸ For trading activities, net income includes profits and losses on instruments held for trading purposes, net of funding costs, plus fees from wholesale broking.

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19. An ADI's total operational risk regulatory capital requirement under the standardised approach to operational risk must be calculated as the sum of the three average results determined in paragraphs 16(c), 17(c) and 18(c) (refer to paragraph 22).
20. An ADI must reconcile, on a timely basis, the calculations set out above, i.e. the last six half-yearly balances of total gross outstanding loans and advances (refer to paragraphs 16 and 17) and adjusted gross income (refer to paragraph 18), with its audited year-end financial statements and, where available, its half-year-end 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 first years of operation). In the event of a merger, aggregated balances must be used unless otherwise agreed to by APRA.
21. 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 22 if, for any given observation, the ADI's adjusted gross income is negative.
22. The total operational risk regulatory capital requirement under the standardised approach to operational risk 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 requirement 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 9 and 10) 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 9, 10 and 11) 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 (as defined in paragraphs 12, 13, 14, and 15) 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)

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