



Prudential Standard APS 110

Capital Adequacy

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that authorised deposit-taking institutions maintain adequate capital, on both an individual and group basis, to support the risks associated with their activities.

This Prudential Standard outlines the overall framework adopted by APRA for the purposes of assessing the capital adequacy of an authorised deposit-taking institution.

This Prudential Standard forms part of a comprehensive set of prudential standards that deal with the measurement of an authorised deposit-taking institution's capital adequacy at Level 1 and Level 2.

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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**) under the Banking Act, subject to paragraph 3.
3. Foreign ADIs,¹ operating through branches in Australia, are not subject to this Prudential Standard. They must, however, be subject to comparable capital adequacy standards in their home country.
4. References to an ADI in this Prudential Standard include, unless otherwise specified, a reference to an Extended Licensed Entity (**ELE**), where APRA has agreed to specific subsidiaries of an ADI being consolidated with the ADI for the purposes of this Prudential Standard (refer to Attachment A).

Responsibility for capital management

5. 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, enables the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved. The Board of directors (**Board**) of an ADI has a duty to ensure that the ADI maintains an appropriate level and quality of capital commensurate with the level and extent of risks to which the ADI is exposed from its activities. An ADI must have in place an Internal Capital Adequacy Assessment Process (**ICAAP**) which includes as a minimum:
 - (a) adequate systems and procedures to identify, measure, monitor and manage the risks arising from the ADI's activities on a continuous basis to ensure that capital is held at a level consistent with the ADI's risk profile; and
 - (b) a capital management plan, consistent with the ADI's overall business plan, for managing the ADI's capital levels on an ongoing basis. Essentially, the plan must set out:
 - (i) the ADI's strategy for maintaining capital resources over time; including outlining its capital target 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

¹ The expression 'foreign ADI' when used in this Prudential Standard has the same meaning as in the *Banking Act 1959*.

- (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 to, and avert, potential breaches of the minimum capital ratios required by APRA.
6. An ADI must ensure its ICAAP is subject to effective and comprehensive review. The frequency and scope of the review must be appropriate to the ADI having regard to the size, business mix and complexity of the ADI's operations and the nature and extent of any change to its business profile and risk appetite. The ADI must, if requested by APRA, provide information on its ICAAP and any subsequent significant changes to its ICAAP.
7. An ADI that is a member of a conglomerate group (refer to Attachment B) could be exposed to risk, including contagion risk, through its association with other members in the group - that is, difficulties encountered by individual entities in the group could be transmitted to the ADI. The Board, in determining the capital adequacy of the ADI, must have regard to:
- (a) group risks posed by other members in the group to the ADI;
 - (b) obligations, both direct and indirect, arising from the ADI's association with group entities that might give rise to a call on the capital of the ADI; and
 - (c) the ability to readily extract capital from another member in the group should the need arise to recapitalise the ADI or other group member. This includes consideration of the integration of the business within the group, the importance of subsidiaries to the group and the impact of taxation, regulatory requirements and other factors on the ability to realise investments in, or transfer surplus capital from, subsidiaries.
8. An ADI that heads a conglomerate group, in addition to maintaining adequate capital for the ADI, must satisfy APRA that the group as a whole has sufficient capital consistent with the group's risk profile. To this end, the Board of an ADI that heads a conglomerate group must:
- (a) establish policies on group capital adequacy (which have regard to the type and distribution of risk and capital resources held by the group) and implement a group capital management plan (with coverage similar to that outlined in paragraph 5(b)) to ensure that the group overall is adequately capitalised to cover its risks 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 capital and 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

9. APRA adopts a tiered approach to the measurement of an ADI's capital adequacy. It assesses the ADI's financial strength at three levels in order to ensure that the ADI is adequately capitalised, both on an individual and a group basis. These levels are:
 - (a) **Level 1** – may be either:
 - (i) the ADI itself; or
 - (ii) the ELE comprising the ADI and all of its APRA-approved subsidiary entities consolidated as a single entity, where APRA has agreed with the ADI that specific subsidiaries of the ADI may be consolidated with it for the purposes of this Prudential Standard;
 - (b) **Level 2** – the consolidated banking group comprising the ADI, its immediate locally incorporated non-operating holding company, if any, and all their subsidiary entities other than non-consolidated subsidiaries (refer to Attachment C); and
 - (c) **Level 3** – the conglomerate group at the widest level.
10. Level 1 and Level 2 assessments are applicable to all ADIs. Level 3 assessment only applies to ADIs prescribed by APRA.
11. Measurement of an ADI's capital adequacy is based on:
 - (a) Level 1 and Level 2 – a risk-based capital adequacy framework aligned with the Basel II Framework (refer to Attachment D); and
 - (b) Level 3 – the methodology agreed with APRA (refer to Attachment E).

Minimum capital adequacy requirements

12. An ADI must, unless APRA sets higher levels (refer to paragraphs 13 and 14 of this Prudential Standard), maintain at Level 1 and Level 2, as a minimum:
 - (a) a **risk-based capital ratio** (refer to Attachment D) of eight per cent at all times; and
 - (b) half of its risk-based capital ratio in the form of Tier 1 capital.
13. APRA may by notice in writing require an ADI to hold, as a minimum, a risk-based capital ratio at a designated level above eight per cent where APRA believes there are prudential reasons for doing so (refer to Attachment F). Where APRA requires an ADI to hold a risk-based capital ratio above eight per cent, a minimum of half the designated level of the ratio must be held in the form of Tier 1 capital, unless APRA determines otherwise.
14. APRA may by notice in writing require an ADI, at Level 1 and Level 2, to hold:

- (a) greater than 50 per cent of its required minimum risk-based capital ratio in the form of Tier 1 capital; or
 - (b) a greater proportion of its Tier 1 capital in the form of Fundamental Tier 1 capital than the minimum levels for such holdings specified in draft² *Prudential Standard Capital Adequacy: Measurement of Capital (APS 111)*.³
15. APRA requires an ADI, as part of its ICAAP, to target and maintain Level 1 and Level 2 capital ratios, for both Tier 1 capital and the capital base,⁴ above the regulatory minima prescribed in this Prudential Standard.
16. An ADI 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 higher Level 1 and Level 2 capital requirements on an ADI in a conglomerate group if it is not satisfied with the group's capital adequacy at Level 3.

Reductions in capital

17. An ADI must obtain APRA's written consent prior to making any planned reduction in its capital, whether at Levels 1, 2 or 3 (refer to Attachment G).

Notification requirements

18. An ADI must inform APRA immediately of any breach or prospective breach of the minimum capital adequacy requirements contained in this Prudential Standard and APS 111 and remedial actions taken or planned to deal with the breach.
19. An ADI must inform APRA as soon as practicable of:
- (a) any significant departure from its ICAAP (refer to paragraphs 5 and 8);
 - (b) any concerns it has about its capital adequacy, whether at Levels 1, 2 or 3, along with proposed measures to address these concerns; and
 - (c) any significant changes in its capital, whether at Levels 1, 2 or 3.

² 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.

³ For the purposes of this Prudential Standard, the term 'Fundamental Tier 1 capital' has the same meaning as in draft *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (draft APS 111)*.

⁴ For the purposes of this Prudential Standard, the term 'capital base' has the same meaning as in draft APS 111.

Attachment A

Extended Licensed Entity

1. APRA may, subject to the specific requirements set out in paragraph 5 of this Attachment, allow an ADI to treat a subsidiary of the ADI, other than an entity regulated directly by APRA or by a foreign equivalent, as part of the ADI itself for the purposes of measuring the ADI's capital adequacy and exposures to related entities. This requires APRA to adopt a "substance over form" approach and to "look through" the legal structure involved. Under this approach, an ADI and all its eligible subsidiary entities are "consolidated" to form an ELE for measuring the ADI's capital adequacy and its exposures to all other related entities. Accordingly, the ADI's exposures to these subsidiaries, including equity investments, are exempted from the ADI's capital adequacy limits on equity and capital investments and intra-group exposure limits prescribed by APRA.
2. An ADI may apply to APRA to have one or more subsidiaries approved as part of its ELE. APRA will seek to identify, in consultation with the ADI, entities that are eligible for approval as part of the ELE. An ADI must inform APRA as soon as it becomes aware that a member of the ELE no longer meets the criteria set out in this Attachment. A subsidiary that no longer meets the criteria must be excluded from the ELE.
3. APRA will, in deciding whether to approve a subsidiary of an ADI as eligible for inclusion within the ELE, have regard to the extent of the ADI's control over, and integration with, the subsidiary as well as the existence of any third-party liabilities of the subsidiary. Potential complications arising if underlying asset holdings must be liquidated during financial stress will also be considered. The following criteria must be met in respect of the relationship between the ADI and the subsidiary:
 - (a) the subsidiary is wholly owned by the ADI, with a Board that is composed entirely of members of the ADI's Board or senior management;
 - (b) the ADI has complete information on the individual assets, liabilities and off-balance sheet positions of the subsidiary. The ADI must be able to provide stand-alone accounting records for the subsidiary, and provide APRA with full and unfettered access to this and any other information at any time, including during on-site visits;
 - (c) the ADI has unrestricted control over the composition of the subsidiary's assets and liabilities. The ADI must demonstrate to APRA that there are no legal or regulatory barriers, including cross-border issues where the subsidiary is not incorporated or established in Australia, to the transfer of any assets or funds back to the ADI. There must be no legal obstacle to the ADI instituting a wind-up of the subsidiary at any time and placing the remaining assets on the balance sheet of the ADI;
 - (d) the ADI manages the assets and liabilities of the subsidiary as part of its internal management practices. This includes reporting structures,

accounting processes, audit arrangements and risk management and measurement systems. The ADI's risk management processes, management information systems and internal controls must be fully extended to the operations of the subsidiary. The senior management of the ADI must monitor the operations of the subsidiary to the same extent as the operations of the ADI itself. Systems for monitoring and control over the subsidiary must be included within the internal and external audit programs of the ADI;

- (e) the subsidiary must not conduct any business that the ADI would otherwise be prevented from doing under its authority to undertake banking business. The ADI must not use the ELE to circumvent APRA's prudential requirements;
 - (f) where the subsidiary holds or invests in assets, other than claims on the ADI, the subsidiary must have no material liabilities (either on-balance sheet or off-balance sheet) to entities other than those that are part of the ELE. Tax liabilities and employee entitlements are exempt from this requirement; and
 - (g) where the subsidiary borrows on behalf of the ADI, all funds must be on-lent directly to the ADI.
5. The requirements in this Attachment are based on a simple arrangement involving an ADI and one or more directly-owned subsidiary entities. This is not intended to preclude, for example, an arrangement in which an ADI invests in a single entity as a holding company and that entity in turn invests in multiple entities. In these circumstances, and provided the holding company is assessed by APRA as meeting the ELE criteria, APRA will "look through" the holding company to determine whether individual entities meet all of the above criteria necessary to be included as part of an ELE. Entities that fail to meet the criteria will be excluded from the ELE.

Attachment B

Conglomerate group

1. For the purposes of this Prudential Standard, a conglomerate group is a group of companies containing one or more locally incorporated ADIs. Any reference to an ADI in this Prudential Standard includes each individual ADI in a conglomerate group.
2. A conglomerate group must be headed by an ADI or an authorised non-operating holding company (**authorised NOHC**) and may include non-financial (commercial) as well as financial entities (regulated and unregulated). A **regulated entity** in a conglomerate group refers to any entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas.
3. A foreign-owned locally incorporated ADI and its subsidiaries constitute a conglomerate group for the purposes of this Prudential Standard. Alternatively, where the foreign-owned ADI has a locally incorporated NOHC parent, the conglomerate group will comprise the locally incorporated NOHC and all its subsidiaries. The ADI's foreign parent(s), the foreign parent's overseas-based subsidiaries and their directly owned non-ADI entities operating in Australia do not form part of the conglomerate group. APRA, however, expects the foreign parent to be subject to regulatory oversight broadly consistent with that applied by APRA and, if requested by APRA, to provide APRA with information concerning activities of its subsidiaries outside the Australian conglomerate group.

Attachment C**Non-consolidated subsidiaries**

1. For the purposes of determining an ADI's capital adequacy at Level 2, all banking and other financial activities, both regulated and unregulated, conducted within the banking group must be consolidated.
2. Consolidation at Level 2 must cover the global operations of an ADI and its subsidiary entities, as well as any other controlled banking entities, securities entities and other financial entities, except for entities involved in the following business activities:
 - (a) insurance businesses (including friendly societies and health funds);
 - (b) acting as manager, responsible entity, approved trustee, trustee or similar role in relation to funds management;
 - (c) non-financial (commercial) operations; and
 - (d) securitisation special purpose vehicles to which assets have been transferred in accordance with APRA's requirements as set out in draft *Prudential Standard APS 120 Securitisation*.

Attachment D

Risk-based capital adequacy framework

1. APRA's approach to the assessment of an ADI's capital adequacy at Level 1 and Level 2 is based on the risk-based capital adequacy framework set out in the Basel II Framework.
2. Consistent with the Basel II framework, the approach provides for a quantitative measure of an ADI's capital adequacy and focuses on:
 - (a) the credit risk associated with an ADI's on-balance sheet and off-balance sheet exposures;
 - (b) the market risk arising from an ADI's trading activities;
 - (c) the operational risk associated with an ADI's banking activities;
 - (d) if APRA requires, the interest rate risk arising from normal financial intermediation, as distinct from trading activities (refer to draft *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (draft APS 117)*); and
 - (e) the amount, form and quality of capital held by an ADI to support these and other exposures.
3. Under the risk-based capital adequacy framework, an ADI's Level 1 and Level 2 capital adequacy are measured by means of a risk-based capital ratio calculated by dividing its capital base by its total risk-weighted assets. That is:

$$\text{risk-based capital ratio} = \frac{\text{capital base}}{\text{total risk-weighted assets}}$$

4. The definition of **capital base**, including qualifying criteria for individual **components of capital**⁵ to be included in an ADI's Level 1 and Level 2 capital base, is set out in draft APS 111.
5. An ADI's **total risk-weighted assets** at Level 1 and Level 2 are calculated as the sum of the total risk-weighted assets determined in accordance with the requirements and procedures set out in draft *Prudential Standards APS 112 Capital Adequacy: Standardised Approach to Credit Risk* or *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*, as applicable. These exposures must then be added to 12.5 times the sum of the capital charges calculated in accordance with draft *Prudential Standards APS 114 Capital Adequacy: Standardised Approach to Operational Risk* *APS 115 Capital*

⁵ The term 'components of capital' is defined in draft APS 111.

Adequacy: Advanced Measurement Approaches to Operational Risk, APS 116
*Capital Adequacy: Market Risk and draft APS 117, as applicable.*⁶

⁶ All references to Prudential Standards are references to the Basel II versions that will take effect from 2008.

Attachment E

Level 3 assessment

1. Only ADIs prescribed by APRA will be subject to Level 3 capital adequacy assessment. APRA will identify conglomerate groups for which it considers Level 2 assessment to be insufficient for measuring an ADI's capital adequacy on a group-wide basis. These could be financial conglomerates containing substantial banking and insurance activity, or mixed conglomerates containing significant banking and non-financial activity.
2. A prescribed ADI must satisfy APRA that the conglomerate group of which it is a part has sufficient capital (as defined in draft APS 111) for the risk profile of the group as a whole.
3. An ADI subject to Level 3 assessment must have an APRA-approved methodology for measuring the group-wide capital adequacy that corresponds to its corporate structure. The methodology must have regard to all group members (whether ADIs, insurers or unregulated entities) and the capacity of any surplus capital to be transferred around the group according to need. The methodology may be based on the methodologies of the Joint Forum or the ADI's own internal capital estimation and allocation models.
4. The policies with regard to group capital adequacy at Level 3, including the methodology used to measure capital adequacy of the entire group, must form part of an ICAAP for the conglomerate group.
5. An ADI must ensure that the ICAAP for the conglomerate group is subject to effective and comprehensive review. The frequency and scope of the review must be appropriate to the ADI having regard to the size, business mix and complexity of the ADI's operations and the nature and extent of any change to its business profile and risk appetite. The ADI must, if requested by APRA, provide information on its ICAAP and any subsequent significant changes to its ICAAP.
6. In determining capital levels for the conglomerate group, the Board of the ADI that heads the group must have regard to:
 - (a) the potential for risk to compound across the group, as well as any proven benefits of risk diversification;
 - (b) concentration of capital and risk within individual entities in the group;
 - (c) the capital needs of individual entities in the group;
 - (d) the nature of capital held by the group, including its maturity, servicing costs and any double counting or upgrading of capital within the group;
 - (e) the ability to readily transfer surplus or free capital within the group and the type of capital which would be available to individual entities from other group members if required (this would involve consideration of the

impact of taxation, regulatory requirements and other factors impinging on the ability to transfer surplus capital among individual entities); and

- (f) the integration of business within the group and the ability of the group to readily realise capital through the sale of business lines and individual member entities without adversely impacting on the group's ongoing operations.
7. Unlike Level 1 and Level 2 capital adequacy assessments, there are no prescribed minimum capital adequacy requirements for Level 3 assessment. Instead, an ADI subject to Level 3 requirements must provide details of its own benchmarks and, on an ongoing basis, details of the extent to which the conglomerate group falls short of these benchmarks.
 8. APRA may impose additional or higher capital requirements on the ADI at Level 1 and Level 2 if APRA is not satisfied with the Level 3 capital adequacy assessment.

Attachment F

Higher minimum ratios

1. In assessing an ADI's overall capital adequacy at Level 1 and Level 2, APRA may take into account other risk factors that have not been incorporated or accounted for in the risk-based capital adequacy framework to ensure that the minimum capital adequacy requirements for the ADI are broadly proportional to its overall risk profiles at Level 1 and Level 2. These factors include, for example, credit risk concentrations, profitability, liquidity, concentration of particular types of assets or liabilities and the effectiveness of the ADI's management systems for monitoring and controlling risks.
2. APRA may consider other factors, including the capital adequacy of subsidiaries of the ADI and any group headed by a holding company of an ADI, in deciding how much capital an ADI needs to hold above the minimum eight per cent requirement at Level 1 and Level 2, and the required minimum levels and composition of Tier 1 capital and the ADI's capital base. All newly established ADIs will generally be subject to a higher minimum risk-based capital ratio, both at Level 1 and Level 2, in their formative years.

Attachment G

Planned reductions in capital

1. For the purposes of this Prudential Standard, a planned reduction in an ADI's capital, whether at Levels 1, 2 or 3, include:
 - (a) share buybacks or the redemption, repurchase or repayment of any qualifying Tier 1 and Tier 2 capital instruments issued by the ADI or by other entities included in the calculation of the ADI's Level 2 or Level 3 capital adequacy;
 - (b) trading in the ADI's own shares or capital instruments outside of any arrangement agreed with APRA in accordance with draft APS 111;
 - (c) payment of dividends on ordinary shares that exceeds an ADI's after-tax earnings, after including any payments on more senior capital instruments, in the financial year to which they relate (refer to draft APS 111); and
 - (d) dividend or interest payments (whether whole or partial) on Upper Tier 2 capital, Innovative Tier 1 capital and Non-innovative Residual Tier 1 capital that exceed an ADI's after-tax earnings, including any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year to which they relate (refer to draft APS 111).⁷
2. An ADI proposing a capital reduction (whether at Levels 1, 2 or 3) must provide APRA with a capital plan covering the respective level(s). The plan should extend for at least two years.
3. An ADI must satisfy APRA that the ADI's capital, at Levels 1, 2 or 3 as appropriate, after the proposed reduction, will remain adequate for its future needs.

⁷ For the purposes of this Prudential Standard, the terms 'Innovative Tier 1 capital' and 'Non-innovative Residual Tier 1 capital' have the same meaning as in draft APS 111.