



## **Prudential Standard APS 111**

### **Capital Adequacy: Measurement of Capital**

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

For capital adequacy purposes, authorised deposit-taking institutions must hold a minimum amount of Tier 1 capital and capital base on both an individual authorised deposit-taking institution (Level 1) basis and consolidated banking group (Level 2) basis. In addition, they may include an amount of Tier 2 capital as part of their required capital holdings, up to the limits specified in this Prudential Standard.

This Prudential Standard sets out the essential characteristics that an instrument must have to qualify as Tier 1 or Tier 2 capital for inclusion in the capital base for assessing Level 1 and Level 2 capital adequacy.

Tier 1 capital comprises the highest quality capital components. Tier 2 capital includes other components that, to varying degrees, fall short of the quality of Tier 1 capital but nonetheless contribute to the overall strength of an institution as a going concern.

For capital adequacy purposes, the capital base at Level 1 and Level 2 is defined as the sum of Tier 1 and Tier 2 capital after all specified deductions and adjustments, subject to the various limits that apply.

The key requirements of this Prudential Standard are that an authorised deposit-taking institution must:

- only include eligible capital as a component of capital for regulatory capital purposes;
- make certain deductions from capital; and
- meet certain limitations with respect to Tier 1 capital and Tier 2 capital.

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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. Except as provided by this paragraph, a foreign ADI, within the meaning of subsection 5(1) of the Banking Act, is not subject to this Prudential Standard. It must, however, be subject to comparable capital adequacy standards in its home country.
4. 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.

## Capital

5. An ADI must, for capital adequacy purposes, hold the minimum levels of capital required by APS 110. As part of these requirements, an ADI must hold Tier 1 capital as defined in, and to the extent required by, this Prudential Standard. In addition, an ADI may include Tier 2 capital, as defined in this Prudential Standard, as part of its required capital holdings up to the limits specified in this Prudential Standard.
6. For the purposes of this Prudential Standard:
  - (a) a **component of capital** is any form of capital defined in this Prudential Standard as eligible for inclusion in Tier 1 capital and Tier 2 capital; and
  - (b) a **category of capital** is a group of components of capital, namely: Fundamental Tier 1 capital, Residual Tier 1 capital - both Non-innovative Residual Tier 1 capital and Innovative Tier 1 capital, Upper Tier 2 capital and Lower Tier 2 capital, as appropriate.

## **Capital base**

7. For capital adequacy purposes, an ADI's **capital base** (i.e. the numerator of the risk-based capital ratio in Attachment D to APS 110) is the sum of Tier 1 and Tier 2 capital, net of all specified deductions and amortisation, subject to the limits that apply under this Prudential Standard.

## **Eligible capital**

8. An ADI must ensure that any component of capital included in the ADI's capital base satisfies, in both form and substance, all applicable requirements in this Prudential Standard for the particular category of capital in which it is included. An ADI must not incorporate a component of capital as part of its capital base where that component does not meet, or is inconsistent with, the requirements in this Prudential Standard.
9. An ADI must not include a component of capital in a particular category of its capital base if that component, when considered in conjunction with other related transactions that affect its overall economic substance, could be reasonably considered not to satisfy fully the requirements in this Prudential Standard for components of that category of capital.
10. An ADI must ensure that the category of capital in which an individual component of capital is included, when measured at an individual group member level (e.g. Level 1 or equivalent), is not upgraded to a higher category of capital when that component is captured in the measure of an ADI's Level 2 capital base. Any such component of capital must be reclassified to the appropriate lower category of capital when measured at Level 2.
11. An ADI must not assign a capital instrument to a particular category of capital, other than those covered by Attachment C, based on a future event, such as the future sale or issuance of a higher quality capital instrument, until such time as:
  - (a) the future event occurs;
  - (b) the future sale or conversion has irrevocably taken place; and
  - (c) the proceeds have been irrevocably received by the ADI.
12. An ADI must provide APRA, as soon as practicable, with copies of documentation associated with the issue of all Tier 1 and Tier 2 capital instruments.
13. Where the terms of an instrument depart from established precedent, an ADI must consult with APRA on the eligibility of a capital instrument for inclusion in the ADI's capital base in advance of the issuance of the capital instrument, and provide APRA with all information it requires to assess the eligibility of the capital instrument.

14. APRA may, in writing, require an ADI to:
  - (a) exclude from its capital base any component of capital that APRA has reasonable grounds to believe does not represent a genuine contribution to the financial strength of the ADI and the consolidated banking group, as appropriate; or
  - (b) reallocate to a lower category of capital a component of capital where APRA has reasonable grounds to believe that it does not fully satisfy the requirements of this Prudential Standard for the category to which it was originally allocated.

### **Application of the Fair Value Option**

15. An ADI may use the Fair Value Option in valuing its financial instruments provided:
  - (a) the ADI complies with all relevant requirements of the Australian accounting standards applicable to the use of the Fair Value Option;
  - (b) the Fair Value Option is only applied to financial instruments for which the ADI is able to reliably estimate fair values;
  - (c) the application of the Fair Value Option is covered by the ADI's risk management systems, including related risk management policies, procedures and controls, both prior to the initial application for a particular activity or purpose and on an ongoing basis; and
  - (d) the ADI otherwise complies with the provisions in this Prudential Standard covering the use of fair values (refer to paragraphs 39(c) to (f), 44(c) to (f), and 52 to 55 inclusive).
16. An ADI must provide information to APRA on its application of the Fair Value Option, as well as related risk management and valuation policies and procedures, including new applications of the Fair Value Option, if requested by APRA.

### **Tier 1 capital**

17. Tier 1 capital comprises the highest quality components of capital that fully satisfy all of the following essential characteristics:
  - (a) provide a permanent and unrestricted commitment of funds;
  - (b) are freely available to absorb losses;
  - (c) do not impose any unavoidable servicing charge against earnings; and
  - (d) rank behind the claims of depositors and other creditors in the event of winding-up.

18. For the purposes of calculating an ADI's capital base, Tier 1 capital is divided into:
- (a) **Fundamental Tier 1 capital**, which is the highest form of capital, consists of:
    - (i) paid-up ordinary shares;<sup>1</sup>
    - (ii) general reserves (excluding any General Reserve for Credit Losses which is included in Upper Tier 2 capital);
    - (iii) retained earnings;
    - (iv) current year earnings;
    - (v) foreign currency translation reserve;
    - (vi) capital profits reserve (representing realised gains on the disposal of revalued assets that have not been transferred from asset revaluation reserves to retained earnings); and
    - (vii) minority interests arising from consolidation of Tier 1 capital of subsidiaries (only for Level 2 calculations); and
  - (b) **Residual Tier 1 capital**, which consists of all other components of capital qualifying for Tier 1 status, is divided into:
    - (i) **Non-innovative Residual Tier 1 capital** – comprising perpetual non-cumulative preference shares that satisfy the relevant criteria set out in Attachment A; and
    - (ii) **Innovative Tier 1 capital** – comprising all other Residual Tier 1 capital instruments that satisfy the relevant criteria set out in Attachment A and Attachment C.
19. General reserves are created after tax and include, but are not limited to:
- (a) reserves from equity-settled share-based payments (share or share options) granted to employees as part of their remuneration package provided that:
    - (i) the share or share options granted relate only to the ordinary shares of the ADI itself; and
    - (ii) there are no circumstances in which such remuneration can be converted into another form (e.g. cash).
- Any other reserves associated with share-based payments must be excluded from capital; and

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<sup>1</sup> This includes ordinary shares issued prior to 1 January 1992 by way of fully paid bonus issue arising from capitalisation of property revaluation reserves. All such shares issued after that date must be included in Upper Tier 2 capital.

- (b) cumulative unrealised gains or losses on hedges<sup>2</sup> offsetting gains or losses included in Tier 1 capital (e.g. movements in the currency value of foreign-currency-denominated hedging instruments that offset movements in foreign-currency-denominated items recognised in the foreign currency translation reserve). This includes fair value gains or losses on derivatives representing effective economic hedges of assets.
20. Current year earnings must take into account:
- (a) negative goodwill;
  - (b) the unwinding of any discount on credit loss provisions (refer to *Guidance Note AGN 220.1 Impaired Facility Definitions*);
  - (c) the proceeds of any dividend reinvestment plan pending the issuance of ordinary shares, as agreed, in writing, with APRA; and
  - (d) expected dividends and tax expenses.
21. Current year earnings also include the full value of upfront fee income provided that:
- (a) the fee income has either been received in cash or has been debited to a customer's account or otherwise forms part of the upfront fees owed by a customer;
  - (b) outstanding amounts of fee income debited to customer accounts must be claimable in full in the event of default by the customer, or capable of being sold as part of outstanding debts to a third party;
  - (c) the provider of the income has no recourse for repayment in part or full of any prepaid income;
  - (d) the customer cannot cancel any fees debited to the customer's account for which they were otherwise obliged to pay upfront; and
  - (e) there is no requirement for the provision of continuing additional services or products associated with the fee income concerned.
22. Fee income can include net positive amounts arising from the netting of deferred income and capitalised expenses associated with a product class provided the conditions set out in paragraph 21 are met.

### **Tier 2 capital**

23. Tier 2 capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 capital stated in paragraph 17 but nonetheless contribute to the overall strength of an entity as a going concern. It is divided into:

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<sup>2</sup> Including cumulative unrealised gains or losses on effective cash flow hedges as defined in the Australian accounting standards.

- (a) **Upper Tier 2 capital** – comprising components of capital that are essentially permanent in nature, including some forms of hybrid capital instrument; and
- (b) **Lower Tier 2 capital** – comprising components of capital that are not permanent i.e. dated or limited life instruments.

*Upper Tier 2 capital*

24. Upper Tier 2 capital consists of the following components that satisfy the relevant criteria set out in Attachment B and Attachment C:
- (a) perpetual cumulative preference shares;
  - (b) perpetual cumulative mandatory convertible notes;
  - (c) perpetual cumulative subordinated debt;
  - (d) any capital amounts otherwise meeting APRA's requirements for Tier 1 capital instruments (refer to Attachment A) that are ineligible for inclusion as Tier 1 capital as a result of the limits in this Prudential Standard;
  - (e) any other hybrid capital instruments of a permanent nature approved, in writing, by APRA;
  - (f) shares issued from 1 January 1992 by way of a fully paid bonus issue arising from capitalisation of property revaluation reserves;
  - (g) a General Reserve for Credit Losses (refer to *Prudential Standard APS 220 Credit Quality (APS 220)* and also Attachment B of this Prudential Standard), unless APRA determines otherwise in writing. The amount of this reserve able to be included as Upper Tier 2 capital is subject to the following limits:
    - (i) for an ADI using the standardised approach to credit risk (refer to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*): a maximum of 1.25 per cent of total risk-weighted on-balance sheet and off-balance sheet assets;
    - (ii) for an ADI using the internal ratings-based (**IRB**) approach to credit risk (refer to *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*): a maximum of 0.6 per cent of total credit risk-weighted assets for non-defaulted exposures, to the extent that total eligible provisions exceed total expected losses;
    - (iii) for an ADI using a partial IRB approach to credit risk: the sum of reserves proportionately based on the limits in paragraphs (i) and (ii); or
    - (iv) where it is not possible for the ADI to determine whether the General Reserves for Credit Losses relate to assets under the

standardised approach to credit risk or the IRB approach to credit risk: allocation on a basis that is reasonable and consistent;

- (h) 45 per cent of pre-tax revaluation reserves of each of the following (subject to satisfying the conditions specified in Attachment B relevant to each reserve):<sup>3</sup>
  - (i) property, including owner-occupied and investment property, that is readily available to be sold;
  - (ii) readily marketable securities that are designated as available for sale in the ADI's or the group's published financial accounts; and
  - (iii) investments in subsidiaries, other than subsidiaries at Level 1 that APRA deems part of an Extended Licensed Entity (**ELE**)<sup>4</sup> and, at Level 2, investments in subsidiaries included in Level 2.

The amount recognised must be net of any fair value gains and losses and any gains or losses on hedges offsetting revaluations included in reserves; and

- (i) 45 per cent of the post-acquisition reserves of associates as defined in the Australian accounting standards.<sup>5</sup> This includes, under equity accounting, the ADI's share of undistributed profits, plus any share of asset revaluations in associates or any other revaluation of investments in associates. The amount recognised must be net of fair value gains and losses and any gains or losses on hedges offsetting revaluations of investments in associates included in reserves.
25. The amount of the General Reserve for Credit Losses to be included in Upper Tier 2 capital is on an after-tax basis. Any deferred tax asset associated with collective provisions (refer to *Guidance Note AGN 220.2 Impairment, Provisioning and the General Reserve for Credit Losses*) eligible to be included in the General Reserve for Credit Losses must be removed.
26. Where an ADI is aware that a particular asset is impaired and a loss arises, such a loss must be reflected in Tier 1 capital. However, where a particular asset belongs to a class of assets for which asset revaluation reserves are included in Upper Tier 2 capital and the asset has been identified as impaired and losses arise, the losses may be offset against any existing revaluations of the asset or class of revalued assets.
27. If an asset revaluation reserve included in Upper Tier 2 capital is negative after adjustment for revaluations of assets included in the reserve, for losses due to

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<sup>3</sup> This amount includes cumulative unrealised gains or losses on effective cash flow hedges. Where a revaluation is calculated net of hedges, the amount of hedges concerned must be excluded from reported Tier 1 capital; i.e. the gains or losses on hedges must be deducted from or added back to Tier 1 capital.

<sup>4</sup> In this Prudential Standard, 'ELE' has the meaning in APS 110.

<sup>5</sup> References to "associates" in this Prudential Standard are to be read as also applying to joint ventures, unless otherwise indicated.

impairment of assets covered by the reserve and for any gains or losses on hedges offsetting revaluations of assets included in the reserve, the amount of deficit in the reserve must be reported as a deduction from Tier 1 capital.

28. Where an ADI is only permitted to recognise the discounted portion of a change in value of an asset in its capital, for the purposes of:
- (a) deducting from capital the value of the asset; or
  - (b) calculating its risk-weighted assets

the ADI need only utilise the value of the asset incorporating the discounted change in its value.

*Lower Tier 2 capital*

29. Lower Tier 2 capital consists of the following components that satisfy the relevant criteria set out in Attachment B and Attachment C:
- (a) term subordinated debt;
  - (b) limited life redeemable preference shares; and
  - (c) any other similar limited life capital instruments approved, in writing, by APRA.

**Dividend and interest payments on Tier 1 and Upper Tier 2 capital instruments**

30. Unless otherwise approved in writing by APRA:
- (a) the aggregate amount of dividend payments on ordinary shares must not exceed, at Level 1 and Level 2, an ADI's after-tax earnings after taking into account any payments on more senior capital instruments, in the financial year to which they relate; and
  - (b) the aggregate amount of dividend or interest payments, whether whole or partial, paid on Upper Tier 2 capital and Residual Tier 1 capital must not exceed, at Level 1 and Level 2, an ADI's after-tax earnings after taking into account any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year to which they relate.

For these purposes, 'financial year' means a period of 12 consecutive months covered by one or more sets of publicly available operating results preceding the date of the proposed payment of dividend or interest. For example, where an ADI makes available half-yearly operating results, a financial year will refer to the preceding two publicly available half-yearly operating results for the ADI.

### **Intra-group capital transactions**

31. The matters APRA may consider in assessing whether a component of capital, resulting from intra-group transactions, does not represent a genuine contribution to financial strength include, but are not limited to, whether a component of capital:
- (a) is clearly supplied from debt raised by other group members;
  - (b) results from intra-group transactions with no economic substance;
  - (c) is contributed by a member of the group using funding sourced, directly or indirectly, from the ADI itself; or
  - (d) is contributed by a group member and the funding of which contains cross-default clauses that would be triggered as a result of the ADI failing to meet any servicing obligations.
32. In assessing the overall capital strength of an ADI on a Level 2 basis, APRA will have regard to the ability of the ADI to readily extract capital from members of the consolidated banking group should the need arise to recapitalise the ADI or other members of the group. In the event that any significant capital support across the group is not readily available, APRA may require an ADI to adjust its Level 2 risk-based capital ratio to reflect the lack of availability of capital.
33. An ADI must, in measuring Level 2 capital, exclude any instrument issued by a member of the Level 2 group, where that instrument is guaranteed by another member of the Level 2 group. This does not apply to guarantees of capital issued by Special Purpose Vehicles (SPVs) in accordance with Attachment C.

### **Holding of shares in group members by other group members**

34. Capital instruments<sup>6</sup> of an ADI, or a member of a group headed by an ADI at Level 2, that are held as direct investments by a vehicle<sup>7</sup> subject to consolidation within the ADI's financial statements in accordance with Australian accounting standards, may only be included in Tier 1 capital and Tier 2 capital (on both a Level 1 and Level 2 basis, as appropriate) if:
- (a) the ADI (or relevant vehicle) did not fund the acquisition of the capital instruments (i.e. acquisition of capital instruments is funded by third parties such as life insurance policyholders or other third-party investors);
  - (b) the risk and rewards associated with the investments are borne primarily by third parties; and

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<sup>6</sup> Capital instruments include ordinary shares and other capital instruments eligible to be included in Tier 1 capital or Upper or Lower Tier 2 capital.

<sup>7</sup> These vehicles exclude any SPV, such as a trust, involved with employee share-based remuneration schemes.

- (c) the ADI can demonstrate to APRA, if required, that decisions to acquire or sell such capital instruments are made independently of the issuer of the capital instruments and in the interests of the third parties who primarily bear the risks and rewards of the investments in the instruments.
35. Direct investments in shares of an ADI by an SPV (e.g. trust) established under a share-based employee remuneration scheme may only be included in the ADI's Tier 1 capital (on a Level 1 and Level 2 basis, as appropriate) where:
- (a) the shares issued to the SPV represent ordinary shares of the ADI;
  - (b) the amount included in Tier 1 capital is matched by an equivalent charge to profit or loss of the ADI for expensing the issue or funding the acquisition of ordinary shares by the vehicle; and
  - (c) the ordinary shares issued cannot be converted to payment in another form (e.g. cash).

For the purposes of measuring capital at Level 2, the SPV holding such shares must be excluded from the consolidated group. As a consequence, any associated change in the fair value of the shares held by such an SPV must be excluded from Level 2 capital and risk-weighted assets.

### **Capital support**

36. For the purposes of this Prudential Standard, in considering whether a facility, including a guarantee, provided to a related party constitutes capital support, APRA will have regard to, amongst other things, whether:
- (a) the facility represents a recognised capital instrument or is otherwise accepted as standing in place of capital required to be held by a related entity; or
  - (b) the provider of the facility, in terms of either repayment or maturity, ranks below other senior unsecured or unsubordinated creditors; or
  - (c) the facility is provided by an ADI or other member of a Level 2 group and the funding provided flows through one member of the group (including any SPV) to another member of the group and the funding received by the second entity meets either (a) or (b).
37. In considering whether a facility (including a guarantee) provided to a non-related party<sup>8</sup> represents capital support, APRA will have regard to, amongst other things, whether:
- (a) the facility represents a recognised capital instrument or is otherwise accepted as standing in place of capital required to be held by the entity; or

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<sup>8</sup> This does not apply to guarantees provided to non-related Registrable Superannuation Entities (RSEs) and RSE licensees.

- (b) the provider of the facility is subordinated to other creditors, and the facility is not otherwise captured by provisions in APS 112 or APS 113 which give regard to the level of subordination in determining capital requirements for such facilities.
38. In the event that a facility covered in paragraphs 36 or 37 represents a form of capital support, it must be considered for the purposes of this Prudential Standard to form part of an ADI's "other capital investments". In the event that such investments are not deducted from Tier 1 capital or Tier 2 capital, they must be risk-weighted at 400 per cent.

## Deductions

### Level 1 deductions

#### *From Tier 1 capital*

39. For the purposes of calculating its Level 1 capital base, an ADI must deduct the following items from Tier 1 capital (also refer to Attachment D):

#### *Asset impairment*

- (a) any identified impairment of an asset where the impairment has not already been taken into account in profit or loss or the impairment has been incorporated in the fair value changes captured in an asset revaluation reserve included in Upper Tier 2 capital (refer to Attachment B). This will include the value of any deficit in asset revaluation reserves included in Upper Tier 2 capital after taking account of all adjustments;

#### *Deferred tax*

- (b) deferred tax assets net of deferred tax liabilities (refer to Attachment D);

#### *Fair value gains and losses*

- (c) cumulative unrealised fair value gains and losses on effective cash flow hedges reflected in retained earnings or reserves included in Tier 1 capital that do not offset gains or losses on revaluations in reserves included in Tier 1 capital;<sup>9</sup>
- (d) any fair value gains and losses relating to illiquid financial instruments. **Illiquid financial instruments** are financial instruments, including instruments covered by effective economic hedges, that do not have a reliable fair value and are to be reported on an amortised cost basis. If fair values can be credibly inferred, the instrument need not be considered "illiquid";

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<sup>9</sup> Any gains on hedges are to be deducted and losses on hedges added back.

- (e) any fair value gains and losses relating to loans and receivables not eligible to be reported using fair values.<sup>10</sup> Such loans and receivables are to be recognised at amortised cost for capital adequacy purposes;
- (f) unrealised fair value gains (or where applicable, adding back unrealised fair value losses), arising from changes in an ADI's own creditworthiness;

*General Reserve for Credit Losses*

- (g) any amounts included in the General Reserve for Credit Losses that have not already been deducted from retained earnings or current year earnings;

*Goodwill and intangibles*

- (h) goodwill, and any other intangible assets arising on an acquisition, net of adjustments to profit or loss reflecting any changes arising from "impairment" of goodwill;<sup>11</sup>
- (i) other intangible assets net of adjustments to profit or loss reflecting amortisation and impairment.<sup>12</sup> This includes capitalised expenses (refer to Attachment D) and the intangible component of investments in subsidiaries<sup>13</sup> that could arise after or outside of acquisitions. Intangible assets are as defined in the Australian accounting standards plus any other assets designated in this Prudential Standard to be intangible;

*Own capital holdings*

- (j) all holdings of own Tier 1 capital instruments, unless exempted by APRA, and any unused trading limit on these instruments agreed with APRA;

*Profits from associates*

- (k) any portion of current year earnings or retained earnings that represents any amount deriving from the ADI's share of undistributed profit or loss in an associate under equity accounting. This amount should be included in Upper Tier 2 capital;

*Revaluation reserves*

- (l) revaluations of assets not held for trading purposes that are passed through profit or loss, unless the revaluations are specifically permitted to be included in Tier 1 capital for the purposes of this Prudential Standard;

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<sup>10</sup> Any gains on revaluations are to be deducted and losses from devaluations added back.

<sup>11</sup> In the case of consolidated financial reports of life companies, other intangible assets include both the value of business in force and the value of new business incorporated in any reported net market value of a subsidiary at the time of acquisition.

<sup>12</sup> Amortisation applies to intangibles with finite useful lives whereas impairment accounting applies to intangibles with infinite useful lives. Refer to Australian accounting standards.

<sup>13</sup> For example, any excess of the reported (market) value of an interest in a subsidiary over the net amount of the subsidiary's tangible assets and liabilities based on the subsidiary's consolidated financial reports.

- (m) any amounts included in revaluation reserves in Upper Tier 2 capital that otherwise would have been included in Tier 1 capital;
- (n) any deficit after taking into account adjustments in the amount available in the respective revaluation reserves for the following items, to the extent not already accounted for in current year earnings or retained earnings:
  - (i) property (owner-occupied and investment property readily available to be sold);
  - (ii) readily marketable securities designated as available for sale;
  - (iii) investments in subsidiaries; or
  - (iv) investments in associates, including any excess of the share of losses in associates under equity accounting;

*Securitisation*

- (o) any gain on sale;<sup>14</sup>
- (p) the difference between the book value and the value realised for transfers of exposures to an SPV where the realised value is less than the book value, unless the difference has been written off to the ADI's profit or loss (refer to APS 120);

*Specific provisions*

- (q) specific provisions (refer to APS 220), including that portion of collective provisions deemed to be a specific provision for regulatory purposes and any prescribed provisions, are ineligible to be included in Tier 1 and Tier 2 capital. To the extent that they have not already resulted in a charge to profit and loss, by way of establishment of a provision in audited published financial accounts, such provisions must be matched by a corresponding reduction in an ADI's Tier 1 capital;

*Superannuation funds*

- (r) any surplus, net of deferred tax liabilities, in any defined benefit superannuation fund of which an ADI is an employer-sponsor, unless otherwise approved in writing by APRA. Any excluded surplus must reverse any associated deferred tax liability from Tier 1 capital; and
- (s) any deficit in a defined benefit superannuation fund of which an ADI is an employer-sponsor and that is not already reflected in Tier 1 capital.

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<sup>14</sup> In this Prudential Standard, 'gain on sale' has the meaning in *Prudential Standard APS 120 Securitisation (APS 120)*

*From Upper or Lower Tier 2 capital (as appropriate)*

*Own capital holdings*

40. An ADI must, unless exempted by APRA in writing, deduct all holdings of own Upper and Lower Tier 2 capital instruments and any unused trading limit in such instruments as determined by APRA in writing (refer to Attachment D).

*From both Tier 1 capital and Tier 2 capital*

41. The following items are to be deducted 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital:

*Equity and capital investments*

- (a) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in other ADIs or equivalent overseas deposit-taking institutions, and their subsidiaries, except where:
- (i) the other ADI or equivalent overseas deposit-taking institution is wholly-owned or effectively controlled, whether directly or indirectly, by the ADI, and has been consolidated with the ADI at Level 2 for capital adequacy purposes. Equity exposures and capital instruments held in such subsidiaries should be risk-weighted at 400 per cent; or
  - (ii) equity exposures and other capital investments of the other ADI or equivalent overseas deposit-taking institution are held for trading purposes which, in this case, must be included in the ADI's total risk-weighted exposures in accordance with *Prudential Standard APS 116 Market Risk (APS 116)*;
- (b) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in holding companies of ADIs and equivalent entities overseas unless held for trading purposes, in which case they must be included in the ADI's total risk-weighted assets in accordance with APS 116;
- (c) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in an insurer, including a holding company of an insurer, or other financial institution (other than an ADI, authorised NOHC of an ADI or equivalent overseas entity), where the ADI holds greater than or equal to 20 per cent and less than or equal to 50 per cent of the voting shares;
- (d) the portion of equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in non-subsidiary entities in excess of:
- (i) 0.15 per cent of the ADI's Level 1 capital base before deductions (at both Tier 1 and Tier 2), for an individual investment; and

- (ii) five per cent of the ADI's Level 1 capital base before deductions (at both Tier 1 and Tier 2), in aggregate;
- (e) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in subsidiaries after deduction of any intangible component, except for equity exposures and other capital investments in subsidiaries that are regulated by APRA or an equivalent regulator overseas. Such equity exposures and other capital investments must be risk-weighted at 400 per cent;

*Guarantees*

- (f) any guarantee, or credit derivative covering a credit exposure of the ADI, that provides for a materiality threshold below which no payment will be made in the event of a loss (refer to APS 112 and APS 113 for limits on amounts an ADI is required to deduct);

*Industry support schemes*

- (g) any non-repayable loans advanced by an ADI under APRA's certified industry support arrangements;

*Securitisation exposures*

- (h) securitisation exposures required to be deducted 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital under APS 120;<sup>15</sup>

*Shortfalls in provisions for credit losses*

- (i) the amount of any expected losses (before any tax effects) in excess of eligible provisions (net of deferred tax assets) calculated in accordance with APS 113; and

*Unsettled non-DvP transactions*

- (j) the amount of value transferred for trades made through a non-delivery-versus-payments (**non-DvP**) system, including any replacement costs, where contractual payment or delivery of the second leg of the transaction does not occur within five business days of the first leg of the transaction (refer to APS 112 and APS 113).

**Other matters pertaining to deductions from Level 1 capital**

- 42. An ADI is not required to deduct an equity exposure (as defined in paragraphs 47 to 50 of APS 113) or other capital investment from Level 1 capital if:
  - (a) the equity exposure or other capital investment forms part of the ADI's trading book;

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<sup>15</sup> For details on treatment of securitisation exposures refer to APS 120.

- (b) the equity exposure is acquired through underwriting of a new equity instrument and the equity instrument is disposed of within 90 days of the date of issue. If the equity instrument is not disposed of within 90 days of issuance, it must be deducted in accordance with the relevant limits for equity exposures and other capital investments unless the position forms part of the ADI's trading book; or
  - (c) the equity exposure or other capital investment is held under a legal agreement on behalf of an external third party, even if held in the name of the ADI.
43. An ADI may, for the purposes of deducting securitisation exposures from capital, net any specific provisions raised against the relevant securitisation exposure. For an ADI using the IRB approach, the amount of any non-refundable purchase price discount on a defaulting asset, and any related specific provisions, may be applied to reduce the amount of the deduction from capital associated with such a securitisation exposure.

## **Level 2 deductions**

### *From Tier 1 capital*

44. For the purposes of calculating its Level 2 capital base, an ADI must deduct the following items from Tier 1 capital (also refer to Attachment D):

### *Asset impairment*

- (a) any identified impairment of an asset where the impairment has not already been taken into account in profit or loss or the impairment has been incorporated in the fair value changes captured in an asset revaluation reserve included in Upper Tier 2 capital (refer to Attachment B). This will include the value of any deficit in asset revaluation reserves included in Upper Tier 2 capital after taking account of all adjustments;

### *Deferred tax*

- (b) deferred tax assets net of deferred tax liabilities (refer to Attachment D);

### *Fair value gains and losses*

- (c) cumulative unrealised fair value gains and losses on effective cash flow hedges reflected in retained earnings or reserves included in Tier 1 capital that do not offset gains or losses on revaluations in reserves included in Tier 1 capital;
- (d) any fair value gains and losses relating to illiquid financial instruments;

- (e) any fair value gains and losses relating to loans and receivables not eligible to be reported utilising fair values.<sup>16</sup> Such loans and receivables are to be recognised at amortised cost for capital adequacy purposes;
- (f) unrealised fair value gains (or where applicable, adding back unrealised fair value losses) arising from changes in an ADI's own creditworthiness;

*General Reserve for Credit Losses*

- (g) any amounts included in the General Reserve for Credit Losses that have not already been deducted from retained earnings or current year earnings;

*Goodwill and intangibles*

- (h) goodwill, and any other intangible assets arising on an acquisition, net of adjustments to profit or loss reflecting any changes arising from "impairment" of goodwill;<sup>17</sup>
- (i) other intangible assets net of adjustments to profit or loss reflecting amortisation and impairment.<sup>18</sup> These include capitalised expenses (refer to Attachment D) and the intangible component of investments<sup>19</sup> in non-consolidated subsidiaries (refer to Attachment B) that do not form part of the consolidated banking group at Level 2. Intangible assets are as defined in the Australian accounting standards plus any other assets designated in this Prudential Standard to be intangible;

*Own capital holdings*

- (j) all holdings of own Tier 1 capital instruments, unless exempted, and any unused trading limit agreed with APRA (refer to Attachment D);

*Profits from associates*

- (k) any portion of current year earnings or retained earnings that represents any amount deriving from the ADI's share of undistributed profit or loss in an associate under equity accounting. Such an amount should be included in Upper Tier 2 capital;

*Revaluation reserves*

- (l) revaluations of assets not held for trading purposes passed through profit or loss, unless the revaluations are specifically permitted to be included in Tier 1 capital for the purposes of this Prudential Standard;
- (m) any amounts included in revaluation reserves in Upper Tier 2 capital that otherwise would have been included in Tier 1 capital;

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<sup>16</sup> Refer to footnote 14.

<sup>17</sup> For example, any excess of the reported (market) value of an interest in a non-consolidated subsidiary over the net amount of the non-consolidated subsidiary's tangible assets and liabilities based on the non-consolidated subsidiary's consolidated financial reports.

<sup>18</sup> Gains on revaluations are to be deducted and losses from devaluations added back.

<sup>19</sup> Refer to footnote 12.

- (n) any deficit after taking into account adjustments in the amount available in the respective revaluation reserves for the following items, to the extent not already accounted for in current year earnings or retained earnings:
  - (i) property (owner-occupied and investment property readily available to be sold);
  - (ii) readily marketable securities designated as available for sale;
  - (iii) investments in unconsolidated subsidiaries; or
  - (iv) investments in associates, including any excess of the share of losses in associates under equity accounting;

*Securitisation*

- (o) any gain on sale;<sup>20</sup>
- (p) the difference between the book value and the value realised for transfers of exposures to an SPV where the realised value is less than the book value, unless the difference has been written off profit or loss;

*Specific provisions*

- (q) specific provisions (refer to APS 220), including that portion of collective provisions deemed to be a specific provision for regulatory purposes and any prescribed provisions, are ineligible to be included in Tier 1 and Tier 2 capital. To the extent that they have not already resulted in a charge to profit or loss, by way of establishment of a provision in audited published financial accounts, such provisions must be matched by a corresponding reduction in an ADI's Tier 1 capital;

*Superannuation funds*

- (r) any surplus, net of deferred tax liabilities, in any defined benefit superannuation fund of which an ADI or other group member is an employer-sponsor unless otherwise approved in writing by APRA. Any excluded surplus must reverse any associated deferred tax liability from Tier 1 capital; and
- (s) any deficit in a defined benefit superannuation fund of which an ADI or other group member is an employer-sponsor and that is not already reflected in Tier 1 capital.

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<sup>20</sup>

Refer to footnote 13.

*From Upper or Lower Tier 2 capital (as appropriate)*

*Own capital holdings*

45. An ADI must, unless exempted by APRA in writing, deduct all holdings of own Upper and Lower Tier 2 capital instruments and any unused trading limit in such instruments determined by APRA in writing (refer to Attachment D).

*From both Tier 1 capital and Tier 2 capital*

46. The following items are to be deducted 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital:

*Equity and capital investments*

- (a) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in other ADIs or equivalent overseas deposit-taking institutions and their subsidiaries, unless these are held for trading purposes in which case they must be included in the ADI's total risk-weighted exposures in accordance with APS 116;
- (b) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in holding companies of ADIs and equivalent overseas entities, unless these are held for trading purposes in which case they must be included in the ADI's total risk-weighted exposures in accordance with APS 116;
- (c) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in an insurer, including a holding company of an insurer, or other financial institution other than an ADI, authorised NOHC or equivalent overseas entity, where the ADI holds greater than or equal to 20 per cent and less than or equal to 50 per cent of the voting shares;
- (d) the portion of equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in non-subsidiary entities in excess of:
  - (i) 0.15 per cent of the ADI's Level 2 capital base before deductions (at both Tier 1 and Tier 2), for an individual investment; and
  - (ii) five per cent of the ADI's Level 2 capital base before deductions (at both Tier 1 and Tier 2), in aggregate;
- (e) equity exposures (as defined in paragraphs 47 to 50 of APS 113) and other capital investments in non-consolidated subsidiaries, whether regulated or unregulated. This deduction does not apply to a subsidiary holding company where it acts as a holding company for pass-through of equity exposures and other capital investments in subsidiary ADIs or equivalent overseas deposit-taking institutions. In the event that a subsidiary holding company holds equity exposures and other capital investments in subsidiaries not eligible for consolidation, an ADI must deduct its equity exposures and other capital investments in the holding company net of the

value of the holding company's investment in any consolidated subsidiary ADI or equivalent overseas deposit-taking institutions;

*Guarantees*

- (f) any guarantee, or credit derivative covering credit exposures at Level 2, that provides for a materiality threshold below which no payment will be made in the event of a loss (refer to APS 112 and APS 113 for limits on amounts an ADI is required to deduct);

*Industry support schemes*

- (g) any non-repayable loans advanced by the ADI under APRA's certified industry support arrangements;

*Securitisation exposures*

- (h) securitisation exposures required to be deducted under APS 120;<sup>21</sup>

*Shortfalls in provisions for credit losses*

- (i) the amount of any expected losses (before any tax effects) in excess of eligible provisions (net of deferred tax assets) calculated in accordance with APS 113; and

*Unsettled non-DvP transactions*

- (j) the amount of value transferred from trades made through a non-DvP system, including any replacement costs, where contractual payment or delivery of the second leg of the transaction does not occur within five business days of the first leg of the transaction (refer to APS 112 and APS 113).

**Undercapitalised non-consolidated subsidiaries**

47. APRA may require an ADI to deduct, from Level 2 capital, an amount to cover the undercapitalisation of a non-consolidated subsidiary (or subsidiaries) of the ADI, as determined by APRA. Any such deduction must be made 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital. The matters APRA may consider in determining the extent of undercapitalisation of a non-consolidated subsidiary of the ADI include, amongst other things, the:

- (a) size and scale of the operations of the non-consolidated subsidiary;
- (b) materiality of the subsidiary's operations to group income and strategic outlook;
- (c) level of net tangible assets of the subsidiary;
- (d) risk profile of the subsidiary;

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<sup>21</sup> For details on the treatment of securitisation exposures refer to APS 120.

- (e) level of exposure of the Level 2 group to the subsidiary; and
- (f) size of any identified capital shortfall and the likelihood of such a shortfall being remedied in the near future.

### **Other matters pertaining to deductions from Level 2 capital**

48. An ADI is not required to deduct equity exposures and other capital investments from Level 2 capital if:
- (a) the equity exposure or capital investment forms part of the ADI's trading book;
  - (b) the equity exposure is acquired through underwriting of a new equity instrument and the equity instrument is disposed of within 90 days of the date of issue. If the equity instrument is not disposed of within 90 days of issuance, it must be deducted in accordance with the relevant limits for equity exposures and other capital investments unless the position forms part of the ADI's trading book; or
  - (c) the equity exposure or other capital instrument is held under a legal agreement on behalf of a party outside the consolidated group.
49. An ADI may, for the purposes of deducting securitisation exposures from capital, net any specific provisions raised against the relevant securitisation exposure. For ADIs using the IRB approach, the amount of any non-refundable purchase price discount on a defaulting asset, and any related specific provisions, may be applied to reduce the amount of the deduction from capital associated with such a securitisation exposure.

### **General rules for deductions**

50. All amounts of assets corresponding to deductions from capital made at Level 1 and Level 2 must be excluded from total assets when calculating an ADI's total risk-weighted assets at the respective level (under APS 112 and APS 113). Notwithstanding that the changes in value of some hedges may be deducted from capital, the credit risk on these hedges must continue to be included in total risk-weighted assets in accordance with Attachment G of APS 112.
51. An ADI that does not hold sufficient capital to absorb required deductions from Tier 2 capital must deduct an amount equivalent to the shortfall in its Tier 2 capital from its Tier 1 capital.

### **Use of fair values**

52. Fair value, including the use of the Fair Value Option, must only be applied to financial instruments for which an ADI is able to reliably estimate fair values.
53. An ADI must have risk management systems including associated policies, procedures and controls that cover the application of fair value measurement in the banking book. The ADI must be able to demonstrate that the use of fair

value measurement and, in particular, the use of the Fair Value Option is managed, monitored and reported in a sound and effective manner, taking into account the scale, complexity and scope of the ADI's operations. These risk management systems must:

- (a) outline the assets and liabilities to be recognised at fair value and the processes for approving use of fair values for new items, products and transactions;
  - (b) enable the ADI to make choices regarding the alternative treatments for categorising financial instruments using fair value measures under accounting practice in a fully informed and disciplined manner;
  - (c) specify the relationship between the application of fair value measures and the ADI's risk management framework;
  - (d) outline methods used for the selection and validation of valuation processes used in calculating and reporting fair values including, where appropriate, independent review, analysis of model stability and performance over a variety of conditions, use of backtesting and frequency of validation. The ADI must retain data and supporting documentation for these purposes;
  - (e) detail the processes for ensuring use of fair values is being applied consistently across the ADI for both reporting and risk management purposes. This should include the frequency at which fair values will be calculated and reported for those assets and liabilities recognised at fair value; and
  - (f) detail how the ADI determines the fair value gains and losses arising from changes in the ADI's own creditworthiness and that of other group members at Level 2.
54. An ADI must supply information, if requested by APRA, to assist APRA in assessing the impact of the application of fair values, in particular the application of the Fair Value Option, on the value of financial instruments for capital adequacy purposes.
55. Where APRA considers that an ADI's policies and procedures for the use of fair values are not reliable or affect adversely its safety and soundness, APRA may, in writing, require an ADI to amend its policies and procedures, to discontinue use of fair value measures for regulatory reporting, or to hold higher levels of capital.

### **Limitations**

56. All required deductions from Level 1 and Level 2 capital must be undertaken prior to calculating any limits applied in paragraph 57.
57. The amounts of Tier 1 and Tier 2 capital included in an ADI's capital base are subject to the following limits:

- (a) Tier 1 capital
  - (i) On and after 1 January 2008:
    - (A) Fundamental Tier 1 capital must constitute at least 75 per cent of **net Tier 1 capital**, (the sum of Fundamental Tier 1 and Residual Tier 1 capital less Tier 1 deductions<sup>22</sup>). This requirement does not apply to mutually owned ADIs in their formative years of operation, where approved in writing by APRA.
    - (B) Residual Tier 1 capital is limited to 25 per cent of net Tier 1 capital. Any excess amount is counted as Upper Tier 2 capital.
    - (C) Innovative Tier 1 capital is limited to 15 per cent of net Tier 1 capital, except for ADIs that are subject to APRA-approved transition arrangements. Any excess amount is counted as Upper Tier 2 capital.
  - (ii) Net Tier 1 capital must constitute at least 50 per cent of an ADI's required capital base. This requirement does not apply to mutually-owned ADIs in their formative years of operation, where approved in writing by APRA.
- (b) Tier 2 capital
  - (i) Total Tier 2 capital (net of all specified deductions and amortisation) is limited to a maximum of 100 per cent of an ADI's net Tier 1 capital. This requirement does not apply to mutually owned ADIs in their formative years of operation, where approved by APRA.
  - (ii) Total Lower Tier 2 capital net of all specified deductions and amortisation is limited to a maximum of 50 per cent of an ADI's net Tier 1 capital. This requirement does not apply to mutually owned ADIs in their formative years of operation, as approved by APRA.

### **IFRS transition arrangements**

58. For the purposes of this Prudential Standard, transitional relief may be granted by APRA, in writing, to an ADI up to 1 January 2010 where its dollar amount of innovative capital instruments exceeds the 15 per cent limit at 1 January 2008. An ADI may include an excess amount agreed by APRA as eligible Innovative Tier 1 capital during the transition period. In determining the excess amount for transition, APRA will limit the amount to the difference between the dollar amount of the ADI's Innovative Tier 1 capital instruments as at 31 August 2005 and the dollar amount of Innovative Tier 1 capital that the ADI would otherwise be entitled to hold had the 15 per cent limit applied to the ADI's Tier 1 capital as at 1 July 2006. The actual excess amount for transition will be agreed with

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<sup>22</sup> Tier 1 deductions refers to all Tier 1 deductions, including that portion of deductions required to be made 50 per cent from Tier 1 capital.

APRA, in writing, based on the ADI's estimated capital base as at 1 January 2008 and any other factors, including other capital management measures undertaken by the ADI.

59. Any unrealised gains resulting from the first-time adoption of the "cost model" for owner-occupied property must be included at full value in Upper Tier 2 capital, subject to regular impairment testing.

#### **Other transition arrangements**

60. An ADI may continue to include in its capital base any instrument that was, before 1 January 2008, eligible for inclusion, but that does not meet the requirements of paragraph 30 and Attachments A and B of this Prudential Standard, until such time as the instrument is repaid, redeemed or converted as applicable. This transitional relief does not extend to new issues of capital instruments or issues under existing capital raisings that occurred on or after 2 July 2007 unless otherwise approved as eligible capital by APRA.<sup>23</sup>

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<sup>23</sup> This is the date that APRA released details of proposed changes to capital requirements for ADIs.

## Attachment A

### Tier 1 capital

#### Residual Tier 1 capital

1. To qualify as Residual Tier 1 capital at Level 1 and Level 2, an instrument must satisfy the following criteria:<sup>24</sup>
  - (a) the instrument is unsecured and paid up:
    - (i) any partly paid issue is eligible only to the extent that it has been paid up. Subject to paragraph 4(d) of this Attachment, unpaid perpetual non-cumulative preference shares issued through “stapled” structures are permitted; and
    - (ii) only the proceeds of the issue that have been received by the issuer are permitted to count as capital;
  - (b) the instrument is perpetual (i.e. it does not have a maturity date):
    - (i) the instrument is not redeemable at the option of the holder and has no provisions which require future redemption by the issuer;
    - (ii) redemption at the option of the issuer is permitted, provided the redemption or call option is subject to APRA’s prior written approval at the time of exercise and it does not operate in conjunction with any other feature that creates or signals a *de facto* tenor of the instrument. If this occurs, APRA will consider the instrument to be a dated instrument and ineligible for inclusion as Tier 1 capital. Issue documentation must give clear and prominent notice to prospective investors that the issuer’s right to exercise any such option to redeem or purchase the instrument is subject to APRA’s prior written approval;
  - (c) the instrument does not impose any fixed servicing costs on the issuer:
    - (i) dividend or interest payments to the holders of the instrument are at the discretion of the issuer. The issuer is able to waive any dividend or interest payments on the instrument and alter the timing of payments;
    - (ii) any unpaid dividends or interest are non-cumulative (i.e. not required to be made up by the issuer at a later date). The instrument, both in form and substance, does not provide for cumulative dividend or interest payments. For example, the instrument does not provide for payment of a higher dividend or interest rate if dividend or interest payments are not made on time or a reduced dividend or

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<sup>24</sup> Capital instruments approved by APRA for Tier 1 status prior to 1 July 2006 are deemed to comply with the criteria set out in paragraph 1 of this Attachment.

interest rate if such payments are made on time. Any special or optional dividends or interest payments on the instrument outside of normal scheduled payments require APRA's prior written approval;

- (iii) the non-payment of a dividend or interest on the instrument does not trigger any restrictions on the issuer other than its ability to pay dividends on ordinary shares, or purchase shares (outside normal trading operations) or retire other shares or pay dividends or interest on more junior capital instruments;
  - (iv) the instrument does not provide for payment of any form of compensation to investors other than by way of a distribution of profits. Any such profit distribution is in the form of a cash dividend or interest payments. Payment in kind is not permitted;
  - (v) dividend or interest payments on the instrument are not linked to the credit standing of the issuer. However, linking dividend or interest payments on the instrument to movements in general market indices is permitted; and
  - (vi) the rate of dividends or interest on the instrument, or the formulae for calculating dividend or interest payments on the instrument, is predetermined and set out in the issue documentation;
- (d) the instrument is able to absorb losses incurred by the issuer on a going concern basis and in the winding-up of the issuer. This includes the following provisions:
- (i) the instrument (both principal and any unpaid dividends or interest) is treated as a specific class of share capital or members' interest of the issuer. The contractual rights of the holders of the instrument to receive and enforce any payments under the instrument are consistent with the intention that the instrument functions as if it constituted a specific class of share capital or members' interest of the issuer;
  - (ii) the issuer does not have any liability to make a dividend or interest payment on the instrument if making the payment would result in the issuer becoming, or being likely to become, insolvent for the purposes of the *Corporations Act 2001* (**Corporations Act**) or, where the issuer is incorporated in a foreign jurisdiction, for the purposes of equivalent corporate insolvency law of that jurisdiction; and
  - (iii) issue documentation makes explicit that:
    - (A) payment of dividends or interest on the instrument is at the discretion of the issuer;
    - (B) failure of the issuer to make a dividend or interest payment on the instrument does not constitute an event of default;

- (C) holders have no right to apply for the winding-up or administration of the issuer, or cause a receiver, or receiver and manager, to be appointed in respect of the issuer on the grounds that the issuer fails to make, or is or may become unable to make, a dividend or interest payment under the instrument; and
  - (D) holders of the instrument will have no offsetting rights or claims on the issuer in the event that the issuer cancels or suspends dividend or interest payments on the instrument;
- (e) the instrument is subordinated in right of repayment of principal, interest and dividends to all depositors and other creditors of the issuer and the issue documentation:
- (i) clearly indicates the subordinated nature of the instrument to prospective holders, and precludes the exercise of any contractual rights of set-off between the instrument and any claims by the issuer on the holders of the instrument;
  - (ii) clearly indicates that the instrument does not represent a deposit liability of an ADI;
  - (iii) does not contain any clauses that could trigger early repayment of debt (e.g. cross-default clauses, negative pledges, restrictive covenants); and
  - (iv) states that the only form of default under the instrument is the winding up of the ADI and that the occurrence of such an event does not prejudice the subordination of the instrument;
- (f) the instrument, where drawn down in a series of tranches, meets the requirements in this Prudential Standard as if each tranche is a capital issue in its own right;
- (g) the instrument does not contain any terms, covenants or restrictions that could inhibit the issuer's ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, or restrict APRA's ability to resolve any problems encountered by the issuer (e.g. clauses preventing further senior debt issues are prohibited);
- (h) there are no cross-default clauses in the documentation of any debt or capital instruments of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise; and
- (i) the instrument is marketed in line with its prudential treatment and does not include any "repackaging" arrangements which have the effect of compromising the permanency of capital raised. If the prospectus or other offering documentation or marketing of the instrument suggests to investors that the instrument has attributes of a lower level of capital than

claimed for prudential treatment, APRA will treat the instrument as an instrument falling into that lower level of capital for prudential purposes.

2. Where an instrument is subject to the laws of a jurisdiction other than Australia or its territories, the ADI must also ensure that the instrument satisfies all relevant qualifying criteria under the laws of that jurisdiction. APRA may require the ADI to provide an independent legal opinion addressed to APRA by a firm or practitioner of APRA's choice, at the expense of the ADI, confirming that the instrument meets all or any of such criteria.
3. An ADI must seek APRA's written approval for any subsequent modification of the terms or conditions of the instrument which may affect its eligibility to continue qualifying as Non-innovative Residual Tier 1 capital or Innovative Tier 1 capital.

### **Non-innovative Residual Tier 1 capital**

4. To qualify as Non-innovative Residual Tier 1 capital at Level 1 and Level 2, perpetual non-cumulative preference shares, in addition to the criteria set out in paragraph 1 of this Attachment, must also satisfy the following criteria:
  - (a) the preference shares have not been issued indirectly through an SPV. An indirect issue is not eligible for inclusion in Non-innovative Residual Tier 1 capital although the preference shares may be included in Innovative Tier 1 capital provided they also satisfy the criteria set out in Attachment C and the relevant criteria in this Attachment;
  - (b) the preference shares do not provide for any step-up in dividends. A conversion from fixed to floating rate (or vice-versa) or a switch in index basis, where there is no change in the effective margin included in the rate of dividend, is not considered a step-up;
  - (c) conversion of the preference shares into ordinary shares is permitted, subject to the following criteria:
    - (i) conversion cannot occur at the option of the holder;
    - (ii) the conversion formula for determining the number of ordinary shares received upon conversion of a preference share must be fixed in the issue documentation and must include a cap on the maximum number of ordinary shares that holders will receive upon conversion;
    - (iii) for the purposes of paragraph 4(c)(ii) of this Attachment, the maximum number of ordinary shares received upon conversion of each preference share must not exceed the ratio of the price of the preference share at issue divided by 50 per cent of the price of the ordinary share at time of issue of the preference shares. For these purposes, in calculating the ordinary share price at time of issue, adjustments may be made for subsequent ordinary share splits, bonus issues and similar transactions;

- (iv) the conversion is not structured in a way that would effectively provide for a return of capital or compensation for unpaid dividends; and
  - (v) any exercise of the conversion option by the issuer is subject to APRA's prior written approval. Approval is not required for any mandatory conversions whose terms were agreed to by APRA prior to issuance of the preference shares;
- (d) perpetual non-cumulative preference shares issued through "stapled" structures are permitted at both Level 1 and Level 2, subject to the following conditions:
- (i) the preference shares are issued directly by an ADI and are "stapled" to securities (**stapled securities**) issued directly by an overseas branch of the ADI. The stapled structure must not involve any use of SPVs and must be simple and transparent;
  - (ii) either or both of the preference shares and the stapled securities are paid up. Any partly paid preference shares or stapled securities are eligible only to the extent that they have been paid up;
  - (iii) the preference shares and the stapled securities are not traded separately and are stapled together unless and until an "unstapling event" occurs;
  - (iv) the terms and conditions of the stapled securities mirror substantially those of the preference shares such that the stapled securities operate effectively as if they were the preference shares. Accordingly, the terms and conditions of the stapled securities do not compromise the Tier 1 qualities of the underlying preference shares;
  - (v) "unstapling" of the preference shares and the stapled securities at the option of the issuer is permitted. The instrument documentation must clearly stipulate the events that will cause the preference shares to be "unstapled" resulting in the stapled securities being extinguished and the holders of the stapled securities holding the preference shares instead. "Unstapling" must take place where:
    - (A) proceedings for liquidation of the ADI commence; or
    - (B) APRA appoints a statutory manager to the ADI pursuant to sub-section 13A(1) of the Banking Act;
  - (vi) issue documentation requires holders of the stapled securities to hold the underlying preference shares upon the occurrence of an unstapling event. Where necessary, APRA may require an independent legal opinion confirming this result (refer to paragraph 2 of this Attachment). To reduce the inherent legal risk associated with unstapling of the structure, the ADI must ensure the clarity,

consistency and certainty with which the contractual terms and conditions are specified in the issue documentation, in particular that:

- (A) all entities involved in the stapled structure have the capacity and power needed to issue the relevant instruments and perform obligations under them;
  - (B) the rights and obligations created by the preference shares and the stapled securities are legal, valid, binding and enforceable on all relevant parties in all relevant jurisdictions; and
  - (C) the “unstapling” mechanism will take effect as contemplated in the issue documentation even if the ADI or other entity has become, or is likely to become, insolvent, including where it is in administration, receivership, winding up or where the ADI has had a statutory manager appointed under the Banking Act; and
- (vii) adequate internal policies and controls are in place such that the unstapling procedures are correctly followed.

### **Innovative Tier 1 capital**

5. To qualify as Innovative Tier 1 capital at Level 1 and Level 2, in addition to the criteria in paragraph 1 of this Attachment, an instrument must also satisfy the following criteria:
- (a) where the instrument provides for a “step-up” in dividends or interest, the terms of the step-up are limited, fixed at the time of issue and subject to APRA’s prior written approval:
    - (i) a step-up in dividends or interest includes the following events:
      - (A) a change in margin on a floating rate instrument;
      - (B) a change in rate on a fixed rate instrument;
      - (C) a conversion from fixed to floating rate (or vice versa), with a change in the effective margin included in the rate of dividend or interest of the instrument; or
      - (D) a switch in the index basis (e.g. from a 3-month to 6-month floating rate or from a 3-month LIBOR to a 3-month BBSW) with a change in the effective margin included in the rate of dividend or interest of the instrument;
    - (ii) a moderate step-up in the rate of dividends or interest is permitted, provided the increase in dividends or interest is no greater than either:

- (A) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or
- (B) 50 per cent of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis;
- (iii) the issue documentation specifies which of the two measures in paragraph 5(a)(ii) of this Attachment is to apply to the instrument. Switching between measures is not allowed;
- (iv) where the step-up involves a conversion from fixed to floating rate (or vice versa), as set out in paragraph 5(a)(i) of this Attachment, or a switch in index basis, the swap spread must be fixed as at the pricing date and reflect the differential in pricing on that date between the initial reference rate and the stepped-up reference rate;
- (v) any step-up in dividends or interest must not be operative within the first 10 years from drawdown; and
- (vi) in principle, only one step-up in dividends or interest is permitted over the life of the instrument. Exceptions for step-ups to be undertaken on multiple occasions (and/or for variable amounts) may be approved by APRA in writing at the time of issuing the instrument;
- (b) a step-up in dividends or interest or an equity conversion is permitted in conjunction with an issuer call option, provided the step-up or equity conversion meets all relevant criteria in paragraphs 5(a) and 5(c) of this Attachment respectively and, where the application of a step-up or equity conversion is optional, the issue cannot mandate the exercise of the call option if the step-up or equity conversion is not applied;
- (c) where the instrument provides for a mandatory conversion or an option to the holders or the issuer to convert into another form of eligible Tier 1 capital instrument, the instrument must not contain any conversion feature that effectively provides for a return of capital or compensation for unpaid dividends or interest. The rate of conversion in all circumstances must be fixed (e.g. by way of a formulae) at the time of issue; and
- (d) where the instrument is issued indirectly through an SPV, it satisfies the criteria set out in Attachment C.

## **Attachment B**

### **Tier 2 capital**

#### **Upper Tier 2 capital**

#### **Asset revaluation reserves**

1. For the purposes of this Prudential Standard, only revaluation reserves arising from the revaluation of property, securities and investments in subsidiaries, other than subsidiaries that APRA deems part of an ELE and associates referred to in paragraphs 2 to 5 of this Attachment can be included in the capital of an ADI.<sup>25</sup>
2. Reserves arising from the revaluation of property can only be included in Upper Tier 2 capital if:
  - (a) the property is owned by an ADI or one of the entities at Level 2;
  - (b) the property represents only land and buildings;
  - (c) the property is readily available to be sold. A property need not be scheduled for sale, nor need a sale be intended. However, such a property must be capable of being readily sold within six months were a decision made to sell the property;
  - (d) the reserves are shown as a component of equity in the audited published financial accounts of the ADI (and the group which it heads);
  - (e) the revaluations are prudent, in accordance with Australian accounting standards, and subject to audit or review consistent with Australian auditing and assurance standards. An investment property must be measured at fair value in accordance with Australian accounting standards; and
  - (f) the amount of reserves incorporates the full effect of any fair value gains and losses and any gains or losses on hedges offsetting revaluations of property (owner-occupied property and investment property) included in the reserves.

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<sup>25</sup> References to an ADI (or to ADIs) in this Attachment apply to an ADI (ADIs) on both Level 1 and Level 2 basis (as defined in APS 110) unless otherwise indicated.

3. Reserves arising from the revaluation of readily marketable securities<sup>26</sup> can only be included in Upper Tier 2 capital if:
  - (a) the securities are designated as “available for sale” assets in the audited published financial accounts of the ADI (or the group which it heads);
  - (b) the securities are held directly by an ADI or a Level 2 entity;
  - (c) the securities are listed or traded on a regulated exchange, or an ADI can otherwise demonstrate to APRA that there is a market for the securities and prices for the securities can be readily and reliably derived;
  - (d) the reserves are shown as a component of equity in the audited published financial accounts of the ADI (or the group which it heads);
  - (e) the revaluations are prudent, in accordance with Australian accounting standards, and subject to audit or review consistent with Australian auditing and assurance standards; and
  - (f) the amount of reserves incorporates the full effect of any fair value gains and losses and any gains or losses on hedges offsetting revaluations of securities included in the reserves.
  
4. Reserves, including any share of undistributed profits in subsidiaries otherwise included in earnings, or arising from the revaluation of investments in subsidiaries (other than subsidiaries that APRA deems to be part of an ELE), may only be included in Upper Tier 2 capital subject to the following conditions:
  - (a) an ADI is able, if required by APRA, to demonstrate that a reliable fair value can be credibly inferred to the subsidiary. This could include demonstrating recent prices received for the sale of entities with similar business profiles, or reliable estimates of the fair value of assets and liabilities of a subsidiary or values derived from other sound valuation practices;
  - (b) the amounts included in the reserves are shown as a component of equity in any published audited financial accounts of the ADI;
  - (c) the revaluations are prudent, in accordance with Australian accounting standards, and subject to audit or review consistent with Australian auditing and assurance standards; and
  - (d) the amount of reserves incorporates the full effect of any fair value gains and losses and any gains or losses on any hedges offsetting revaluations of the investments in subsidiaries.

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<sup>26</sup> For these purposes, units in listed trusts are included. An ADI may recognise changes in the value of quoted units in a trust or SPV but may not look through to changes in the value of underlying assets of the trust or SPV themselves.

5. Reserves representing an ADI's share of profits in associates or revaluation of assets in associates under equity accounting plus any reserves otherwise arising from the revaluation of investments in associates are to be included in Upper Tier 2 capital subject to the following conditions:
  - (a) where reserves simply reflect investments in associates and are revalued, an ADI is able, if required by APRA, to demonstrate that a reliable fair value can be credibly inferred to the investment in the associate. This could include demonstrating recent prices received for the sale of equity interest in the associate or by way of sale of entities with similar business profiles, or reliable estimates of the fair value of assets and liabilities of the associate or values derived from other sound valuation practices;
  - (b) the amounts included in the reserves are shown as a component of equity in any published audited financial accounts of the ADI;
  - (c) any revaluations are prudent, in accordance with Australian accounting standards, and the amounts reported in the reserves are subject to audit or review consistent with Australian auditing and assurance standards; and
  - (d) the amount of reserves incorporates the full effect of any fair value gains and losses and any gains or losses on any hedges offsetting revaluations of the investments in subsidiaries.

### **General Reserve for Credit Losses**

6. If a General Reserve for Credit Losses has not already resulted in a charge to profit or loss (e.g. by way of establishment of a general reserve or provision in audited published financial accounts), a General Reserve for Credit Losses reported for capital purposes must be matched by a corresponding reduction in an ADI's Tier 1 capital.

### **Hybrid capital instruments**

7. To qualify as Upper Tier 2 capital at Level 1 and Level 2, an instrument must satisfy the following criteria:<sup>27</sup>
  - (a) the instrument is unsecured and paid up and, in particular:
    - (i) any partly paid issue is eligible only to the extent that it has been paid up; and
    - (ii) only the proceeds of the issue that have been received by the issuer are permitted to count as capital;
  - (b) the instrument is perpetual (i.e. it must have no maturity date) and:

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<sup>27</sup> Capital instruments approved by APRA for Upper Tier 2 status prior to 1 July 2006 will be deemed to comply with the criteria set out in this Attachment.

- (i) the instrument is not redeemable at the option of the holder and must have no other provisions which require future redemption by the issuer; and
  - (ii) redemption at the option of the issuer is permitted, provided the redemption or call option is subject to APRA's prior written approval at the time of exercise and it does not operate in conjunction with any other feature that creates or signals a *de facto* tenor of the instrument. If this occurs, APRA will treat the instrument as a dated instrument and as ineligible for inclusion as Upper Tier 2 capital. Issue documentation must give clear and prominent notice to prospective investors that the issuer's right to exercise any such option to redeem or purchase the instrument is subject to APRA's prior written approval;
- (c) the instrument, where drawn down in a series of tranches, meets the requirements in this Prudential Standard as if each tranche were a separate capital issue in its own right;
- (d) cumulative dividend or interest payments on the instrument are permitted, subject to the following:
- (i) the instrument must allow the issuer an option to defer dividend or interest payments where profitability does not justify a dividend or interest payment (refer to paragraph 30 of the Prudential Standard);
  - (ii) where an instrument does not provide the issuer with the option to defer dividends or interest when profitability does not justify payment, such an instrument must be assessed as a Lower Tier 2 capital instrument;
  - (iii) while unpaid dividends or interest to the holders of the instrument can be accumulated, they must not be compounded. For example, the instrument must not provide for payment of a higher dividend or interest rate if dividend or interest payments are not made on time, nor a reduced dividend or interest rate if such payments are made on time;
  - (iv) the non-payment of a dividend or interest on the instrument must not trigger any restrictions on the issuer other than its ability to pay dividends on ordinary shares, or purchase shares (outside normal trading operations) or retire other shares, or pay dividends or interest on more junior capital instruments;
  - (v) the instrument must not provide for payment of any form of compensation to investors other than by way of a distribution of a dividend or interest payment subject to the issuer having sufficient profits. Any such profit distribution must be in the form of a cash dividend or interest payments. Payment in kind is not permitted;

- (vi) dividend or interest payments on the instrument must not be linked to the credit standing of the issuer. However, linking dividend or interest payments on the instrument to movements in general market indices is permitted; and
  - (vii) the rate of dividends or interest on the instrument, or the formulae for calculating dividend or interest payments on the instrument, must be predetermined and set out in the issue documentation;
- (e) the instrument is able to absorb losses incurred by the issuer on a going concern basis and in the winding-up of the issuer, and in particular:
- (i) instrument (both principal and any unpaid dividends or interest) is treated as a specific class of share capital or members' interest of the issuer in the event that the issuer's retained earnings become negative. The contractual rights of the holders of the instrument to receive and enforce any payments under the instrument must be consistent with the intention that the instrument functions as if it constituted a specific class of share capital or members' interest of the issuer in this situation;
  - (ii) issuer does not have any liability to make a scheduled dividend or interest payment on the instrument if making the payment would result in the issuer becoming, or being likely to become, insolvent for the purposes of the Corporations Act or, where the issuer is incorporated in a foreign jurisdiction, for the purposes of equivalent corporate insolvency law of that jurisdiction;
  - (iii) issue documentation makes explicit that:
    - (A) the issuer has the right to defer dividend or interest payments on the instrument in accordance with paragraphs 7(d)(i) and/or 7(e)(ii);
    - (B) failure of the issuer to make a scheduled dividend or interest payment on the instrument does not constitute an event of default; and
    - (C) holders have no right to apply for the winding-up or administration of the issuer, or cause a receiver, or receiver and manager, to be appointed in respect of the issuer on the grounds that the issuer fails to make, or is or may become unable to make, a scheduled dividend or interest payment under the instrument; however, in the event of liquidation, holders may claim previously deferred dividend and interest payments that remain unpaid;
- (f) the instrument is subordinated in right of repayment of principal and interest and dividends to all depositors and other creditors of the issuer, except those creditors (not depositors) expressed to rank equally with or

behind the holders of the instrument and the issue documentation and, in particular, the instrument:

- (i) clearly indicates the subordinated nature of the instrument to prospective holders, and must preclude the exercise of any contractual rights of set-off between the instrument and any claims by the issuer on the holders of the instrument;
  - (ii) clearly indicates that the instrument does not represent a deposit liability of an ADI;
  - (iii) does not contain any clauses that could trigger early repayment of debt (e.g. cross default clauses, negative pledges, restrictive covenants);
  - (iv) states that the only form of default under the instrument is the winding up of the ADI, provided such an event does not prejudice the subordination of the instrument; and
  - (v) states that the only remedies for an event of default are to prove for an unpaid amount contractually due in the event of liquidation or administration of the issuer;
- (g) the instrument does not provide for any accelerated repayment of principal, except in the event of liquidation or winding-up of the issuer. The winding-up must be irrevocable, i.e. either by way of a court order or an effective resolution by shareholders or members. The making of an application to wind-up, or the appointment of a receiver, administrator or official with similar powers, including the exercise of APRA's powers under section 13A(1) of the Banking Act, are not sufficient to accelerate repayment of the instrument;
- (h) where the instrument provides for a mandatory conversion or an option to the holders or the issuer to convert into share capital of the issuer, the instrument does not contain any conversion feature that effectively provides for a return of capital or compensation for unpaid dividends or interest. The rate of conversion is fixed (e.g. by way of a formula) at the time of issue;
- (i) where the instrument provides for a "step-up" in dividends or interest, the terms of the step-up are limited, fixed at the time of issue and subject to APRA's prior written approval:
- (i) a step-up in dividends or interest includes the following events:
    - (A) a change in margin on a floating rate instrument;
    - (B) a change in rate on a fixed rate instrument;
    - (C) a conversion from fixed to floating rate (or vice versa), with a change in the effective margin included in the rate of dividend or interest of the instrument; or

- (D) a switch in the index basis (e.g. from a 3-month to 6-month floating rate or from a 3-month LIBOR to a 3-month BBSW) with a change in the effective margin included in the rate of dividend or interest of the instrument;
- (ii) moderate step-up in the rate of dividends or interest is permitted, provided the increase in dividends or interest is no greater than either:
  - (A) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or
  - (B) 50 per cent of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis;
- (iii) the issue documentation specifies which of the two measures mentioned in paragraph 7(i)(ii) of this Attachment is to apply to the instrument. Switching between measures is not allowed;
- (iv) where the step-up involves a conversion from fixed to floating rate (or vice versa), as noted in paragraph 7(i)(i) of this Attachment, or a switch in index basis, the swap spread must be fixed as at the pricing date and reflect the differential in pricing on that date between the initial reference rate and the stepped-up reference rate;
- (v) any step-up in dividends or interest must not be operative within the first 10 years from drawdown; and
- (vi) in principle, only one step-up in dividends or interest is permitted over the life of the instrument. Exceptions for step-ups to be undertaken on multiple occasions (and/or for variable amounts) may be approved by APRA in writing at the time of issuing the instrument;
- (j) a step-up in dividends or interest or an equity conversion is permitted in conjunction with an issuer call option, provided the step-up or equity conversion meets all relevant criteria in paragraphs 7(h) and 7(i) of this Attachment respectively and, where the application of a step-up or equity conversion is optional, the issue cannot mandate the exercise of the call option if the step-up or equity conversion is not applied;
- (k) the instrument does not contain any terms, covenants or restrictions that could inhibit the issuer's ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, or restrict APRA's ability to resolve any problems encountered by the issuer (e.g. clauses preventing further senior debt issues);
- (l) there are no cross-default clauses in the documentation of any debt or other capital instruments of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise;

- (m) the instrument is marketed in line with its prudential treatment, and must not include any “repackaging” arrangements that have the effect of compromising the permanency of capital raised. If the prospectus or other offering documentation or marketing of the instrument suggests to investors that the instrument has attributes of a lower level of capital than claimed for prudential treatment, APRA will treat the instrument as an instrument falling into that lower level of capital for prudential purposes;
- (n) the ADI has satisfied itself (where appropriate by obtaining written opinion from relevant legal advisers), on reasonable grounds, that at the time of issue of the instrument the right to defer dividend or interest payments as provided for in paragraph 7(e)(iii)(A) is binding on holders of the instrument. An ADI must, if required by APRA, be able to demonstrate the grounds on which it satisfied itself in this regard;
- (o) where the instrument is subject to the laws of a jurisdiction other than Australia or its territories, the ADI must also ensure that the instrument satisfies all relevant qualifying criteria under the laws of that jurisdiction. APRA may require the ADI to provide an independent legal opinion addressed to APRA by a firm or practitioner of APRA’s choice, at the expense of the ADI, confirming that the instrument meets all or any of such criteria;
- (p) any subsequent modification of the terms or conditions of the instrument, which may affect its eligibility to continue qualifying as Upper Tier 2 capital, is subject to APRA’s prior written consent; and
- (q) where the instrument is issued indirectly through an SPV, it must also satisfy the criteria set out in Attachment C.

### **Lower Tier 2 capital**

8. To qualify as Lower Tier 2 capital at Level 1 and Level 2, an instrument must satisfy the following criteria:
- (a) the instrument is unsecured and paid up:
    - (i) any partly paid issue is eligible only to the extent that it has been paid up;
    - (ii) only the proceeds of the issue that have been received by the issuer are permitted to count as capital;
  - (b) the instrument has a minimum term of five years. Where the instrument:
    - (i) is drawn down in a series of tranches, it must meet the requirements in this Prudential Standard as if each tranche is a separate capital issue in its own right and the minimum original maturity of each tranche must be five years from the date of drawdown;

- (ii) provides holders with the right or option to demand repayment prior to maturity, the first possible repayment date is regarded as the effective maturity date of the instrument;
- (iii) offers the issuer a redemption or call option prior to maturity, issue documentation must give clear and prominent notice to prospective investors that the issuer's right to exercise any such option to repay, purchase, or otherwise redeem the instrument is subject to APRA's prior written approval; and
- (iv) the amount of the instrument eligible for inclusion in Lower Tier 2 capital is to be amortised on a straight line basis at a rate of 20 per cent per annum over the last four years to maturity as follows:

<b>Years to Maturity</b>	<b>Amount Eligible for Inclusion in Lower Tier 2 Capital</b>
More than 4	100 per cent
Less than and including 4 but more than 3	80 per cent
Less than and including 3 but more than 2	60 per cent
Less than and including 2 but more than 1	40 per cent
Less than and including 1	20 per cent

- (c) issue documentation makes explicit that all scheduled dividend or interest payments on the instrument are conditional upon the issuer being solvent at the time of payment and no payment may be made unless the issuer is solvent immediately afterwards. Failure of the issuer to make any scheduled dividend or interest payments in this case does not constitute an event of default. An instrument may continue to accrue interest on any unpaid amounts. This can include interest on deferred interest payments;
- (d) the instrument must not provide for payment of a higher dividend or interest rate if dividend or interest payments are not made on time, or a reduced dividend or interest rate if such payments are made on time;
- (e) dividend or interest payments on the instrument are not linked to the credit standing of the issuer. However, linking dividend or interest payments on the instrument to movements in general market indices is permitted;
- (f) the rate of dividends or interest on the instrument, or the formulae for calculating dividend or interest payments on the instrument, is predetermined and set out in the issue documentation;
- (g) where the instrument provides for a step-up in dividends or interest, the terms of the step-up are limited, fixed at the time of issue and subject to APRA's prior written approval:
  - (i) a step-up in dividends or interest includes the following events:

- (A) a change in margin on a floating rate instrument;
  - (B) a change in rate on a fixed rate instrument;
  - (C) a conversion from fixed to floating rate (or vice versa), with a change in the effective margin included in the rate of dividend or interest of the instrument; or
  - (D) a switch in the index basis (e.g. from a 3-month to 6-month floating rate or from a 3-month LIBOR to a 3-month BBSW) with a change in the effective margin included in the rate of dividend or interest of the instrument;
- (ii) moderate step-up in the rate of dividends or interest is permitted, provided the increase in dividends or interest is no greater than either:
- (A) 50 basis points, less the swap spread between the initial index basis and the stepped-up index basis, for an issue with a maturity up to 10 years;
  - (B) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis, for an issue with a maturity of more than 10 years; or
  - (C) 50 per cent of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis;
- (iii) the issue documentation specifies which of the three measures in paragraph 8(g)(ii) of this Attachment is to apply to the instrument. Switching between measures is not allowed;
- (iv) where the step-up involves a conversion from fixed to floating rate (or vice versa), as noted in paragraph 8(g)(i) of this Attachment, or a switch in index basis, the swap spread must be fixed as at the pricing date and reflect the differential in pricing on that date between the initial reference rate and the stepped-up reference rate;
- (v) any step-up in dividends or interest must not be operative within the first five years from drawdown; and
- (vi) in principle, only one step-up in dividends or interest is permitted over the life of the instrument. Exceptions for step-ups to be undertaken on multiple occasions (and/or for variable amounts) may be approved by APRA in writing at the time of issuing the instrument;
- (h) a step-up in dividends or interest is permitted in conjunction with an issuer call option, provided the step-up meets all relevant criteria set out in paragraph 8(g) of this Attachment and, where the application of a step-up is optional, the issue cannot mandate the exercise of the call

option if the step-up is not applied. Otherwise, the instrument is deemed to mature on the date at which the step-up provisions take effect;

- (i) the instrument is subordinated in right of repayment of principal and interest to all depositors and other creditors of the issuer, except those creditors (not depositors) expressed to rank equally with or behind the holders of the instrument and the issue documentation clearly indicates:
  - (i) the subordinated nature of the instrument to prospective holders, and precludes the exercise of any contractual rights of set-off between the instrument and any claims by the issuer on the holders of the instrument; and
  - (ii) that the instrument does not represent a deposit liability of an ADI;
- (j) in the event that the issuer defaults under the terms of the instrument, remedies available to the holders are limited to actions for specific performance, recovery of amounts currently outstanding or the winding-up of the issuer. The amounts which may be claimed in the event that the issuer defaults can include any accrued unpaid dividends and interest, including market interest on these unpaid amounts. All such unpaid dividends and interest must be subordinated to the claims of depositors and other creditors of the issuer;
- (k) the instrument does not provide for any accelerated repayment of principal, except in the event of liquidation or winding-up of the issuer. The winding-up must be irrevocable i.e. either by way of a court order or an effective resolution by shareholders or members. The making of an application to wind-up, or the appointment of a receiver, administrator, or official with similar powers, including the exercise of APRA's powers under section 13A(1) of the Banking Act are not sufficient to accelerate repayment of the instrument;
- (l) the instrument does not contain any terms, covenants or restrictions that could inhibit the issuer's ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, or restrict APRA's ability to resolve any problems encountered by the issuer (e.g. clauses preventing further senior debt issues);
- (m) there are no cross-default clauses in the documentation of any debt or other capital instruments of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise;
- (n) where the instrument is subject to the laws of a jurisdiction other than Australia or its territories, the ADI must also ensure that the instrument satisfies all relevant qualifying criteria under the laws of that jurisdiction. APRA may require the ADI to provide an independent legal opinion addressed to APRA by a firm or practitioner of APRA's choice, at the expense of the ADI, confirming that the instrument meets all or any of such criteria;

- (o) any subsequent modification of the terms or conditions of the instrument, which may affect its eligibility to continue qualifying as Lower Tier 2 capital, is subject to APRA's prior written consent; and
- (p) where the instrument is issued indirectly through an SPV it must also satisfy the criteria set out in Attachment C.

## Attachment C

### Criteria for capital issues involving use of SPVs

1. Capital instruments issued through SPVs (including any in the ELE) must satisfy the following criteria:
  - (a) the SPV issuing the instrument is a single purpose non-operating entity established for the sole purpose of raising capital for the ADI or for a consolidated subsidiary of the ADI. The SPV should have no liabilities outside the capital instrument it issues, and its assets should not exceed materially the amount of the capital instrument issued. The SPV must not be able to operate independently of the ADI or its relevant subsidiary;
  - (b) the proceeds of the instrument issued by the SPV are fully invested in the capital instrument issued by the ADI or its relevant subsidiary. The proceeds must flow immediately into the ADI or its relevant subsidiary;
  - (c) the terms and conditions of the instrument issued by the ADI or its relevant subsidiary mirror substantially those included in the instrument issued by the SPV. Essentially, both instruments must be unsecured, fully paid-up (any partly paid issue is eligible only to the extent that it has been paid-up) and subordinated to all depositors and other creditors of the ADI or its relevant subsidiary. They must have the same maturity;
  - (d) to satisfy the essential characteristic of loss absorption for Tier 1 and Upper Tier 2 capital instruments and to activate this loss absorption ability well before any serious deterioration in the ADI's financial position, the instrument issued by the SPV must permit the absorption of losses in the event of any of the following:
    - (i) APRA determines in writing that the ADI has a Tier 1 capital ratio of less than five per cent or a total Tier 1 and Tier 2 capital ratio of less than eight per cent at Level 1 and/or Level 2;
    - (ii) APRA issues a written directive to the ADI under section 11CA of the Banking Act for the ADI to increase its capital;
    - (iii) APRA appoints a statutory manager to the ADI pursuant to sub-section 13A(1) of the Banking Act or proceedings are commenced for the winding-up of the ADI; or
    - (iv) retained earnings have become negative;
  - (e) unless otherwise agreed, in writing, with APRA, the mechanism used to satisfy the loss absorption requirement in paragraph 1(d) of this Attachment is mandatory conversion into ordinary shares or non-cumulative irredeemable preference shares of the ADI or its relevant subsidiary as appropriate. The rate of conversion must be fixed (e.g. by way of a formulae) at the time of subscription to the instrument. The ADI or its relevant subsidiary must maintain a sufficient margin of authorised

but unissued share capital to enable such conversion to take place at any time;

- (f) the instrument issued by the SPV is not covered by a guarantee of the issuer or related entity or any other arrangement that legally or economically enhances the seniority of the holders vis-à-vis depositors, other creditors and subordinated debt holders of the ADI or its relevant subsidiary;
- (g) the main features of the instrument issued by the SPV and the structure of the issue are transparent and easily understood by investors. An issue is not eligible for inclusion in an ADI's capital base at Level 1 or Level 2 where the complexity of its structure raises doubt over the legal and regulatory risk associated with it; and
- (h) the key features of Tier 1, Upper or Lower Tier 2 capital instruments issued by the SPV must be disclosed in the ADI's published annual accounts. This disclosure must include:
  - (i) the name of the entity issuing the instrument and the name of the entity receiving the ultimate proceeds of the issue;
  - (ii) the amount and currency denomination of the instrument;
  - (iii) the jurisdiction in which the instrument was issued and other jurisdictions whose laws might apply;
  - (iv) the dividend or interest rate payable on the instrument, including any provisions for step-up or supplementary dividends. Where the instrument pays a participating dividend based on dividends paid on ordinary shares, the formulae for calculating payments must be set out;
  - (v) any provisions for the exercise of call options or triggering conversion of the instrument; and
  - (vi) the triggers and mechanisms used to achieve loss absorption.

## Attachment D

### Capital deductions

#### Deferred tax assets and deferred tax liabilities

1. An ADI must net from Tier 1 capital the amount of its:
  - (a) deferred tax assets, except for any deferred tax assets associated with collective provisions eligible to be included in the General Reserve for Credit Losses (refer to *Guidance Note 220.2 Impairment, Provisioning and the General Reserve for Credit Losses*); and
  - (b) deferred tax liabilities, except for any amounts associated with surpluses in any ADI (or other group member) employer-sponsored superannuation funds.

An ADI must net these items on a consistent basis for the purposes of this Prudential Standard. In the event that deferred tax liabilities exceed the amount of deferred tax assets, the excess cannot be added to Tier 1 capital (i.e. the net deduction is zero).

2. Netting of deferred tax assets and deferred tax liabilities must only be applied where:
  - (a) an ADI or member of a group which the ADI heads has a legally enforceable right to set-off current tax assets against current tax liabilities where they relate to income taxes levied by the same taxation authority and the taxation authority permits the ADI or group members to make or receive a single net payment; and
  - (b) the deferred tax assets and deferred tax liabilities relate to income taxes levied by the same authority on either:
    - (i) the same taxable member of a group; or
    - (ii) different taxable members of a group for which group policies and procedures have been established that provide for the relevant group members to settle current tax assets and liabilities on a net basis, or to realise the assets and liabilities simultaneously, in each future period in which significant amounts of deferred tax assets or liabilities are to be settled or recovered; and
    - (iii) for direct or indirect subsidiaries of the ADI incorporated outside Australia for which:
      - (A) it is claimed current tax assets and liabilities will be settled on a net basis; and
      - (B) netting may have a material impact on any amount of deferred tax assets an ADI may be required to deduct from its capital

the group headed by the ADI must have written opinions from relevant external auditors and legal advisors that the relevant tax authorities allow, or would allow, netting of deferred tax assets and deferred tax liabilities. An ADI must be able to provide relevant written auditor or legal opinions to APRA, if requested.

3. An ADI must:
  - (a) have procedures in place to monitor changes in relevant laws and taxation practices that may affect the written opinions it is required to have covering netting of deferred tax assets and deferred tax liabilities; and
  - (b) ensure that the written opinions are updated in the event of changes in laws or taxation practices overseas that could materially impact on overseas taxation authorities continuing to allow netting of deferred tax assets and deferred tax liabilities.

### **Investments**

4. Investments in another entity at Level 1 and Level 2 include equity exposures (as defined in paragraphs 47 to 50 of APS 113) and, in the case of an APRA-regulated institution or an overseas equivalent, holdings of debt instruments issued by the entity that qualify as regulatory capital. Investments include holdings of units in a trust.
5. For the purposes of this Prudential Standard, the amount of equity exposures (as defined in paragraphs 47 to 50 of APS 113) and any other capital investments, including any excess equity holdings in non-subsiary entities, that must be deducted from capital is the book value of the equity exposure or other capital investment, including any amount by which they have been revalued. Any intangible component of equity exposures or other capital investments must be deducted from Tier 1 capital. In the case of investments in a subsidiary, this would be calculated as the excess of the book value over the net tangible assets of the subsidiary.
6. Where the amount of equity exposures (as defined in paragraphs 47 to 50 of APS 113) and any other capital investments, including any excess equity exposures in non-subsiary entities, held by an ADI is revalued, and the ADI is permitted to include in its capital only the discounted portion of the increase in value of the equity exposures and other capital investments, the ADI need only deduct from its capital the value of equity exposures and other capital investments included in its risk assets incorporating the discounted portion of any revaluation included in the ADI's capital.
7. Where any investments in non-consolidated subsidiaries, including minority interests, (refer to Attachment B of APS 110) have been incorporated for accounting purposes into the ADI's consolidated group accounts, the consolidation of these entities must be reversed prior to the calculation of risk-based capital ratios at Level 2; that is, any retained earnings, other reserves or minority interests of these entities included in, and any other items impacting on Level 2 Tier 1 capital as a result of the accounting consolidation must be

removed from Level 2 Tier 1 capital for capital adequacy purposes. Goodwill and any other intangible component of the investments in non-consolidated subsidiaries must be deducted from the ADI's Tier 1 capital at Level 2.

### **Holdings of own capital instruments**

8. For the purposes of this Prudential Standard, an ADI or member of a group headed by an ADI may, as a result of membership of a dealer panel, trading or other activities agreed with APRA, undertake limited purchases of its own Tier 1 and Tier 2 capital instruments, or capital instruments issued by other members of the group (refer to APS 110). Such purchases are subject to a limit agreed with APRA, and the amount equal to the limit (or alternatively any actual holdings plus unused limit) must be deducted from Tier 1, Upper or Lower Tier 2 capital as appropriate, both at Level 1 and Level 2. This requirement does not apply to holdings of capital instruments by members of a group on behalf of third parties.

### **Capitalised expenses**

9. Intangible assets include capitalised expenses and capitalised transaction costs. These expenses must be deducted from Tier 1 capital at both Level 1 and Level 2, and include:
  - (a) loan/lease origination/broker fees and commissions that are capitalised as an asset are to be set off against the balance of upfront loan/lease fees associated with the lending portfolios that are treated as deferred income and recognised as a liability. The positive balance of the net loan/lease origination fees and commissions must be deducted from Tier 1 capital. A negative balance may be added to Tier 1 capital provided the net deferred income satisfy the criteria in this Prudential Standard. Otherwise, a negative balance must not be added to capital;
  - (b) costs associated with debt raisings and other similar transaction-related costs that are capitalised as an asset;
  - (c) costs associated with issuing capital instruments if not already charged to profit or loss;
  - (d) capitalised information technology software costs;
  - (e) start-up and other establishment costs of a securitisation that are capitalised as an asset, and are to be set-off against the balance of fee income relating to securitisation schemes recognised and deferred as a liability. Any positive net balance must be deducted from Tier 1 capital (refer to APS 120). Any up-front fee income received in excess of the capitalised securitisation establishment cost may be added to Tier 1 capital provided it meets the criteria in this Prudential Standard; and
  - (f) other capitalised expenses including capitalised expenses of a general nature such as strategic business development initiatives. These also include, in addition to the above listed items, other forms of transaction

costs and like costs are required to be deferred/capitalised and amortised as part of the measurement of assets and liabilities under Australian accounting standards.

10. The balance of any transaction costs and like items that are capitalised and deferred as an asset must be netted off against the balance of any income deferred as a liability relating to the products giving rise to the capitalised transaction costs (i.e. only deferred costs and income in particular product portfolios may be netted). Any positive net balance of capitalised transaction costs must be deducted from Tier 1 capital in accordance with this Prudential Standard. Any surplus of up-front fee income received over deferred costs may be added to Tier 1 capital provided the up-front fee income received satisfies the criteria set in this Prudential Standard. Otherwise, up-front fee income received must not be added to capital.

### **Surpluses on employer-sponsored defined benefit superannuation funds**

11. An ADI must deduct from Tier 1 capital any surplus in an ADI (or member of the ADI's group) employer-sponsored defined benefit superannuation fund unless it has already been excluded from Tier 1 capital or unless otherwise agreed with APRA. An ADI may make representations to APRA to include a surplus as an asset for capital adequacy purposes where the ADI (or member of the ADI's group) employer-sponsor is able to demonstrate unrestricted and unfettered access to a fund surplus in a timely manner. Where APRA is satisfied about such access, an ADI may include the surplus in its risk-weighted assets at a 100 per cent risk weight. This surplus will no longer be required to be deducted from Tier 1 capital.