



24 April 2008

## To IRB/AMA Accredited Authorised Deposit-Taking Institutions (ADIs)

### Clarification of Basel II Prudential Standards for ADIs with IRB/AMA Accreditation

A number of ADIs have sought clarification as to the application of the Basel II capital adequacy prudential standards.

#### 1. Level 2 Regulatory Capital Calculation

In some instances, APRA's capital adequacy rules may differ to those applied in other jurisdictions. Where an ADI has a banking subsidiary authorised in a country outside of Australia, that subsidiary is required to comply with the capital adequacy requirements of the relevant jurisdiction for the purpose of regulatory reporting to the relevant supervisor. However, for the purpose of Level 2 regulatory reporting to APRA, the ADI must ensure that data for the consolidated banking group (which includes the foreign subsidiary) complies with Australian capital adequacy prudential standards, unless an alternative approach has been agreed with APRA.

#### 2. Treatment of Provisions and Reserves for Credit Losses under APS 111 and APS 113

ADIs have also sought clarification on the application of paragraphs 19 and 21 of Prudential Standard *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113); in particular, the application of the taxation adjustments in measuring for regulatory capital purposes the General Reserve for Credit Losses (GRCL), Expected Losses (EL) and Eligible Provisions (EP). This in turn has a bearing on the amount of the GRCL eligible to be included in Upper Tier 2 Capital under paragraph 24(g) of Prudential Standard *APS 111 Capital Adequacy: Measurement of Capital*.

In general, a balance sheet item that is 'tax effected' includes any benefit or decrement associated with income tax. This is predominantly an issue of timing arising from the difference between an item's tax value (called its tax base) and the carrying value on the ADI's balance sheet. In the case of provisions, a deferred tax asset arises when the carrying amount of the provision is greater than its tax base. For prudential purposes, the value of this tax benefit cannot be recognised: it has been long-standing prudential policy that tax benefits (after netting of any deferred tax liabilities) must be excluded from capital.

ADIs are required to make an adjustment to their regulatory capital base for the difference between their EL and EP. EL is the amount of expected losses calculated in accordance with APS 113. Consistent with the policy of giving no recognition of tax benefits, the Standard makes no allowance for any reduction in expected loss amounts due to potential future taxation benefits obtained from loan write-offs. EP is defined in paragraph 19 of APS 113 and primarily includes an ADI's specific provisions - that is, individual provisions plus those collective provisions required for regulatory purposes to be treated as specific provisions - and its GRCL net of (ie excluding) any associated deferred tax assets (refer paragraph 19(a) of APS 113 and paragraph 25 of APS 111).

Taken together, APS 111 and APS 113 require that:

- if EL is greater than EP, then the difference must be deducted 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital (refer paragraph 22 of APS 113).
- if EL is less than EP, only that portion of surplus EP made up of eligible GRCL for non-defaulted exposures is permitted to be included in Upper Tier 2 capital, up to a limit of 0.6 per cent of total credit risk-weighted assets (refer paragraph 23 of APS 113); or
- if EL equals EP, then no adjustment to capital is required.

Sincerely

A handwritten signature in black ink, appearing to read 'Wayne Byres', is centered below the word 'Sincerely'. The signature is written in a cursive style with a large initial 'W'.

Wayne Byres  
Executive General Manager - Diversified Institutions Division