Prudential Standard APS 110

Capital Adequacy

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires an authorised deposit-taking institution (ADI) to maintain adequate capital, on both a Level 1 and Level 2 basis, to act as a buffer against the risk associated with its activities.

The ultimate responsibility for the prudent management of capital of an ADI rests with its Board of directors. The Board must ensure the ADI maintains an appropriate level and quality of capital commensurate with the type, amount and concentration of risks to which the ADI is exposed.

The key requirements of this Prudential Standard are that an ADI and any Level 2 group must:

- have an Internal Capital Adequacy Assessment Process;
- maintain required levels of regulatory capital;
- operate a capital conservation buffer and, if required, a countercyclical capital buffer;
- inform APRA of any adverse change in actual or anticipated capital adequacy; and
- seek APRA's approval for any planned capital reductions.

Table of contents

Attachments

Authority

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

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (ADIs) under the Banking Act, subject to paragraph 3.

3. This Prudential Standard does not apply to a **foreign ADI**. A foreign ADI must, however, be subject to comparable capital adequacy standards in its home country. This Prudential Standard does not apply to **purchased payment facility providers** (**PPF providers**), which are subject to separate prudential requirements.

4. A reference to an ADI in this Prudential Standard, unless otherwise indicated, is 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.

5. If an ADI to which this Prudential Standard applies is:

   (a) the holding company for a group of bodies corporate, the ADI must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable; or

   (b) 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.

Interpretation

6. Terms that are defined in *Prudential Standard APS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.

Responsibility for capital management

7. Capital is the cornerstone of an ADI's financial strength. It supports an ADI's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enables the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved.

8. Capital management must be an integral part of an ADI's risk management, by aligning its risk appetite and risk profile with its capacity to absorb losses.

9. The Board of directors (Board)[1] of an ADI has a duty to ensure that the ADI maintains a level and quality of capital commensurate with the type, amount and concentration of risks to which the ADI is exposed from its activities. In doing so, the Board must have regard to any prospective changes in the ADI's risk profile and capital holdings.

10. An ADI that is a member of a group may be exposed to risks, including reputational and contagion risk, through its association with other members of the group. Problems arising in other group members may compromise the financial and operational position of the ADI. The Board, in determining the capital adequacy of the ADI at Level 1, must have regard to:

    (a) risks posed to the ADI by other members of the group, including the impact on the ability of the ADI to raise funding and additional capital should the need arise;

    (b) obligations, both direct and indirect, arising from the ADI's association with group members that could give rise to a call on the capital of the ADI;

    (c) the ability to freely transfer capital (including situations where the group is under financial or other forms of stress) from members of the group to recapitalise the ADI or other members of the group. This includes consideration of:

        (i) the integration of business operations within the group;

        (ii) the importance of members of the group to the group;

        (iii) the impact of cross-border jurisdictional issues;

        (iv) differences in legislative and regulatory requirements that may apply to group members; and

        (v) the impact of taxation and other factors on the ability to realise investments in, or transfer surplus capital from, group members.

Internal Capital Adequacy Assessment Process

11. An ADI must have an Internal Capital Adequacy Assessment Process (ICAAP) that must:

    (a) be adequately documented, with the documentation made available to APRA on request; and

    (b) be approved by the Board initially, and when significant changes are made.

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[1] Unless otherwise indicated, a reference to the Board of an ADI in this Prudential Standard is also a reference, where relevant, to the Board of the entity that heads the Level 2 group.

12. An ADI's ICAAP must be appropriate to the ADI's size, business mix and complexity of its operations and group structure (as applicable).

13. An ADI that is part of a group may rely on the ICAAP of the group provided that the Board of the ADI is satisfied that the group ICAAP meets the criteria in paragraph 14 in respect of the ADI.

14. The ICAAP must include at a minimum:

   (a) adequate policies, procedures, systems, controls and personnel to identify, measure, monitor and manage the risks arising from the ADI's activities on a continuous basis, and the capital held against such risks;

   (b) a strategy for ensuring adequate capital is maintained over time, including specific capital targets set out in the context of the ADI's risk profile, the Board's risk appetite and regulatory capital requirements. This includes plans for how target levels of capital are to be met and the means available for sourcing additional capital where required;

   (c) actions and procedures for monitoring the ADI's compliance with its regulatory capital requirements and capital targets. This includes the setting of triggers to alert management to, and specified actions to avert and rectify, potential breaches of these requirements;

   (d) stress testing and scenario analysis relating to potential risk exposures and available capital resources;

   (e) processes for reporting on the ICAAP and its outcomes to the Board and senior management of the ADI, and for ensuring that the ICAAP is taken into account in making business decisions;

   (f) policies to address the capital impact of material risks not covered by explicit regulatory capital requirements; and

   (g) an ICAAP summary statement as defined in paragraph 15.

15. The ICAAP summary statement is a high-level document that describes and summarises the capital assessment and management processes of the ADI. It must outline at a minimum the aspects of the ICAAP listed in paragraphs 14(a) to (f). The ICAAP summary statement must also include:

   (a) a statement of the objectives of the ICAAP, the expected level of financial soundness associated with the capital targets and the time horizon over which the ICAAP applies;

   (b) a description of the key assumptions and methodologies utilised by the ADI in its ICAAP, including stress testing and scenario analysis;

   (c) triggers for reviewing the ICAAP in light of changes to business operations, regulatory, economic and financial market conditions, group structure (as applicable) and other factors affecting the ADI's risk profile and capital resources;

(d) a summary of the ADI's policy for reviewing its ICAAP, including who is responsible for the review, details of the frequency and scope of the review, and mechanisms for reporting on the review and its outcomes to the Board and senior management;

(e) a description of the basis of measurement of capital used in the ICAAP, and an explanation of the differences where this basis differs from that used for regulatory capital; and

(f) references to supporting documentation and analysis as relevant.

16. An ADI must ensure that its ICAAP is subject to regular and robust review by appropriately qualified persons who are operationally independent of the conduct of capital management. The frequency and scope of the review must be appropriate to the ADI, having regard to its size, business mix, complexity of its operations and group structure (as applicable), and the nature and extent of any changes that have occurred or are likely to occur in its business profile or its risk appetite. A review must be conducted at least every three years. The review must be sufficient to reach a view on whether the ICAAP is adequate and effective.

17. An ADI must, on an annual basis, provide a report on the implementation of its ICAAP to APRA (ICAAP report). A copy of the ICAAP report must be provided to APRA no later than three months from the date on which the report has been prepared.

18. The ICAAP report must include:

(a) detailed information on current and three-year projected capital levels relative to minimum regulatory capital requirements and target levels;

(b) detailed information on the actual outcomes of applying the ICAAP over the period, relative to the planned outcomes in the previous ICAAP report (including analysis of the ADI's actual capital position relative to minimum regulatory capital requirements and capital targets and actual-versus-planned capital management actions);

(c) a description of material changes to the ICAAP since the previous ICAAP report;

(d) detail and outcomes of stress testing and scenario analysis used in undertaking the ICAAP;

(e) a breakdown of capital usage over the planning horizon, as relevant, by material:

(i) business activity;

(ii) group members;

(iii) geographic spread of exposures; and

(iv) risk types.

(f) an assessment of anticipated changes in the ADI's risk profile or capital management processes over the planning horizon;

(g) details of any review of the ICAAP since the previous ICAAP report, including any recommendations for change and how those recommendations have been, or are being, addressed; and

(h) references to supporting documentation and analysis as relevant.

19. The ICAAP report submitted to APRA by the ADI must be accompanied by a declaration approved by the Board and signed by the CEO stating whether:

(a) capital management has been undertaken by the ADI in accordance with the ICAAP over the period and, if not, a description of, and explanation for, deviations;

(b) the ADI has assessed the capital targets contained in its ICAAP to be adequate given the size, business mix and complexity of its operations and, at Level 2, given the location of operations of group members and the complexity of the group structure; and

(c) the information included in the ICAAP report is accurate in all material respects.

Measurement of capital adequacy

20. APRA uses a tiered approach to the measurement of an ADI's capital adequacy. It assesses the ADI's financial strength at three levels in order to ensure that the ADI is adequately capitalised, both on an individual and a group basis. These levels are:

(a) Level 1 – either:

(i) the ADI itself; or

(ii) the extended licensed entity (ELE) (refer to *Prudential Standard APS 222 Associations with Related Entities*);

(b) Level 2 – either

(i) if the ADI is not a subsidiary of an authorised NOHC and the ADI has subsidiaries in addition to those included in its ELE, the consolidation of the ADI and all its subsidiary entities other than non-consolidated subsidiaries; or

(ii) if the ADI is a subsidiary of an authorised NOHC, the consolidation of the immediate parent NOHC of the ADI and all the immediate parent NOHC's subsidiary entities (including any ADIs and their subsidiary entities) other than non-consolidated subsidiaries;

unless APRA otherwise determines, in writing, a different Level 2 composition for a group of companies of which the ADI is a member; and

(c) **Level 3** – the conglomerate group at the widest level[2].

Minimum capital adequacy requirements

21. APRA will, in writing, determine prudential capital requirements (PCRs) for an ADI. The PCRs, expressed as a percentage of total risk-weighted assets, will be set by reference to **Common Equity Tier 1 Capital**, **Tier 1 Capital** and **Total Capital**. PCRs may be determined at Level 1, Level 2 or both.

22. The minimum PCRs that an ADI must maintain at all times are:

(a) a Common Equity Tier 1 Capital ratio of 4.5 per cent;

(b) a Tier 1 Capital ratio of 6.0 per cent; and

(c) a Total Capital ratio of 8.0 per cent.

APRA may, in writing, determine higher PCRs for an ADI and may, in writing, change an ADI's PCRs at any time.

23. An ADI must maintain risk-based capital ratios above its PCRs at all times. Risk-based regulatory capital ratios are to be calculated in accordance with Attachment A.

Capital conservation buffer

24. From 1 January 2016, an ADI must hold a capital conservation buffer above the PCR for Common Equity Tier 1 Capital.

25. The capital conservation buffer is 2.5 per cent of the ADI's total risk-weighted assets, unless determined otherwise by APRA in writing. The sum of the Common Equity Tier 1 PCR plus the capital conservation buffer determined by APRA will be no less than 7.0 per cent of the ADI's total risk-weighted assets.

26. Any amount of Common Equity Tier 1 Capital required to meet an ADI's PCRs for Tier 1 Capital or Total Capital, above the amount required to meet the PCR

[2] Capital requirements at Level 3 are determined by APRA separately to this Prudential Standard.

for Common Equity Tier 1 Capital, is not eligible to be included in the capital conservation buffer.

27. Capital distribution constraints will apply when an ADI's Common Equity Tier 1 Capital ratio falls within the capital buffer ranges outlined in Table 1 of Attachment B. Capital distribution constraints apply to distributions that affect Common Equity Tier 1 Capital. Items considered to be distributions for these purposes include:

    (a) dividends and share buybacks;

    (b) discretionary payments on **Additional Tier 1 Capital** instruments[3]; and

    (c) discretionary bonus payments to staff[4].

28. An ADI may apply to APRA to make payments in excess of the constraints imposed by the capital conservation buffer regime. APRA will only grant approval where it is satisfied that an ADI has established measures to raise capital equal to or greater than the amount above the constraint that it wishes to distribute.

Countercyclical capital buffer

29. From 1 January 2016, APRA may, by notice in writing to all ADIs, require them to hold additional Common Equity Tier 1 Capital, of between zero and 2.5 per cent of total risk-weighted assets, as a countercyclical capital buffer.

30. Any countercyclical capital buffer is to be applied in accordance with Attachment C.

31. APRA will inform ADIs of any decision to set, or increase, the level of the countercyclical capital buffer up to 12 months before the date from which it applies. Any decision by APRA to decrease the level of a countercyclical capital buffer will take effect immediately.

32. Any countercyclical capital buffer is to be applied by extending the range of the capital conservation buffer. Capital distribution constraints, as set out in Attachment B, will apply if an ADI's Common Equity Tier 1 Capital ratio falls within the extended capital buffer range (consisting of the capital conservation buffer plus any countercyclical capital buffer).

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[3] All payments of dividends or interest on eligible Additional Tier 1 capital instruments are, by definition, required to be discretionary.

[4] This would include any remuneration payments that are made upon the exercise of a discretionary judgment of the Board or senior management of an ADI as to the amount or timing of payment.

Reductions in capital

33. An ADI or authorised NOHC (as applicable) must obtain APRA's written approval prior to making any planned reduction in capital, whether at Level 1 or Level 2.

34. A planned reduction in an ADI's capital includes:

    (a) a share buyback or the redemption, repurchase or repayment of any qualifying **Common Equity Tier 1 Capital, Additional Tier 1 Capital** and **Tier 2 Capital** instruments issued by the ADI (or by other entities included in the calculation of the ADI's Level 2 capital adequacy);

    (b) trading in the ADI's own shares or capital instruments outside of any arrangement agreed with APRA in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111); and

    (c) the aggregate amount of dividend payments on ordinary shares that exceeds an ADI's after-tax earnings after taking into account any payments on more senior capital instruments, in the financial year[5] to which they relate.

35. An ADI or authorised NOHC (as applicable) proposing a capital reduction (whether at Level 1 or Level 2) must provide APRA with a forecast showing, at the respective Levels, the projected future capital position after the proposed capital reductions. The forecast should extend for at least two years.

36. An ADI must satisfy APRA that the ADI's capital, at Level 1 and Level 2 as appropriate, will remain adequate for its future needs after a proposed reduction.

Notification requirements

37. An ADI or an authorised NOHC (as applicable) must notify APRA, in accordance with section 62A of the Banking Act, of any breach or prospective breach of the capital requirements contained in this Prudential Standard and inform APRA of any remedial actions taken or planned to deal with the breach.

38. An ADI or an authorised NOHC (as applicable) must inform APRA as soon as practicable of any:

    (a) significant departure from its ICAAP;

    (b) concerns it has about its capital adequacy (including projected losses), whether at Level 1 or Level 2, and the measures it proposes to take to address these concerns;

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5 '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.

(c) indication of significant adverse changes in market pricing of, or trading in, the capital instruments of the ADI or group of which it is a member (including pressures on the ADI to purchase its own capital instruments); and

(d) other significant adverse changes in its capital, whether at Level 1 or Level 2.

Adjustments and exclusions

39. APRA may by notice in writing adjust or exclude a specific prudential requirement in this Prudential Standard in relation to one or more specified ADIs or authorised NOHCs[6].

[6] Refer to subsection 11AF(2) of the Act.

Attachment A

Risk-based regulatory capital ratios

1. APRA's approach to the assessment of an ADI's capital adequacy is based on the risk-based capital adequacy framework set out in the Basel Committee on Banking Supervision's publications, *International Convergence of Capital Measurement and Capital Standards A Revised Framework* (Basel II), revised in June 2006 and *A global regulatory framework for more resilient banks and banking systems* (Basel III), released in December 2010 and revised in June 2011.

2. Consistent with Basel III, the approach provides for a quantitative measure of an ADI's capital adequacy and focuses on:

   (a) the credit risk associated with an ADI's on-balance sheet and off-balance sheet exposures (refer to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113), as applicable);

   (b) the operational risk associated with an ADI's banking activities (*Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk* (APS 114) and *Prudential Standard APS 115: Advanced Measurement Approaches to Operational Risk* (APS 115), as applicable);

   (c) the market risk arising from an ADI's trading activities (*Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116));

   (d) where applicable, the interest rate risk arising from normal financial intermediation, as distinct from trading activities (*Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* (APS 117));

   (e) the risks associated with securitisation in accordance with *Prudential Standard APS 120 Securitisation* (APS 120); and

   (f) the amount, form and quality of capital held by an ADI to act as a buffer against these and other exposures.

3. An ADI's Tier 1 Capital is the sum of its Common Equity Tier 1 Capital and Additional Tier 1 Capital. Its Total Capital is the sum of Tier 1 Capital and Tier 2 Capital. The criteria for inclusion in Common Equity Tier 1 Capital, Additional Tier 1 Capital and Tier 2 Capital are set out in APS 111.

4. Under APRA's risk-based capital adequacy framework, an ADI's capital adequacy is measured by means of risk-based capital ratios calculated by

dividing each of its Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital by its total risk-weighted assets. That is:

$$\textit{Common Equity Tier 1 Capital ratio} = \frac{\textit{Common Equity Tier 1 Capital}}{\textit{Total risk-weighted assets}}$$

$$\textit{Tier 1 Capital ratio} = \frac{\textit{Tier 1 Capital}}{\textit{Total risk-weighted assets}}$$

$$\textit{Total Capital ratio} = \frac{\textit{Total Capital}}{\textit{Total risk-weighted assets}}$$

where total risk-weighted assets are calculated as the sum of:

(a) risk-weighted on-balance sheet and off-balance sheet assets determined in accordance with APS 112;

(b) risk-weighted assets determined under APS 113;

(c) 12.5 times the sum of the capital charges determined under APS 114, APS 115, APS 116 and APS 117; and

(d) risk-weighted assets determined under APS 120,

to the extent that each of these Prudential Standards applies to the ADI.

Attachment B

Constraints on capital distributions

1. Capital distribution constraints apply when an ADI's Common Equity Tier 1 Capital ratio is within the capital buffer (CB) range (consisting of the capital conservation buffer plus any countercyclical capital buffer). The capital buffer range is divided into four quartiles for the purposes of determining the minimum capital conservation ratios, as set out in Table 1.

Table 1: Minimum capital conservation standards

Minimum capital conservation standards	
Common Equity Tier 1 Capital ratio	**Minimum capital conservation ratios (expressed as a percentage of earnings)**
Within first quartile of buffer PCR to < (PCR + 0.25CB)	100
Within second quartile of buffer (PCR + 0.25CB) to < (PCR + 0.50CB)	80
Within third quartile of buffer (PCR + 0.50CB) to < (PCR + 0.75CB)	60
Within fourth quartile of buffer (PCR + 0.75CB) to < (PCR + CB)	40
Above top of buffer (PCR + CB)	0

2. The minimum capital conservation ratios in Table 1 represent the percentage of earnings that an ADI is unable to distribute where its Common Equity Tier 1 Capital ratio falls within the corresponding quartile. Where the Common Equity Tier 1 Capital ratio falls within the first quartile, an ADI must also cease all Tier 1 Capital distributions.

3. Earnings are defined as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after the tax that would have been reported had none of the distributable items been paid. As such, any tax impact of making such distributions is reversed out.

4. Payments made by an ADI that do not result in a depletion of Common Equity Tier 1 Capital are not considered to be distributions for the purposes of this Attachment. APRA may impose restrictions on capital distributions in accordance with paragraph 34(c) of this Prudential Standard, even where an ADI’s Common Equity Tier 1 Capital ratio is above the capital conservation buffer.

5. APRA may, by notice in writing, impose limits on the period in which an ADI may operate within the capital conservation buffer range, on a case-by-case basis.

Attachment C

Countercyclical capital buffer

1. An ADI with credit exposures in geographic locations outside Australia must calculate any countercyclical capital buffer requirement as the weighted average of the buffers that are applied by the regulatory authorities in jurisdictions in which the ADI has exposures. Credit exposures include all private sector credit exposures (including non-ADI financial sector exposures) that attract a credit risk capital charge or the risk-weighted equivalent trading book capital charges for specific risk, incremental risk (IRC, refer to APS 116) and securitisation.

2. The weighting applied to the buffer in each jurisdiction will be the ADI's total credit risk charge that relates to private sector credit exposures in that jurisdiction, divided by the ADI's total credit risk charge that relates to private sector credit exposures across all jurisdictions.

3. When determining the jurisdiction to which a private sector credit exposure relates, ADIs must use an ultimate risk basis, where possible. An ADI must use the country where the guarantor of the exposure resides, not where the exposure has been booked.

4. APRA may require an ADI to apply a higher countercyclical capital buffer for a particular jurisdiction than may be imposed by the host authority in that jurisdiction.

5. For Level 2 purposes, the countercyclical capital buffer must cover all exposures incurred in relevant jurisdictions, even though the business may be undertaken by a member of the Level 2 group that is not itself an ADI or equivalent overseas institution.

6. For Value-at-Risk (VaR)-specific risk included in calculating a countercyclical buffer, an ADI must consult with APRA to develop an approach that would translate IRCs and comprehensive risk measurement charges into individual instrument risk-weights that would then be allocated to the geographic location of the specific counterparties that make up the charge.