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

Authority.....3

Application.....3

Interpretation.....3

Responsibility for capital management.....3

Internal Capital Adequacy Assessment Process.....4

Measurement of capital adequacy.....7

Minimum capital adequacy requirements.....8

Capital conservation buffer.....8

Countercyclical capital buffer.....9

Leverage ratio.....9

Reductions in capital.....9

Notification requirements.....10

Adjustments and exclusions.....11

Attachments

Attachment A — Risk-based regulatory capital ratios.....12

Attachment B — Constraints on capital distributions.....14

Attachment C — Countercyclical capital buffer.....16

Attachment D — Leverage ratio.....17

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) a **foreign ADI**, which must, however, be subject to comparable capital adequacy standards in its home country; or

   (b) a **purchased payment facility provider** (**PPF provider**).

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.

7. Where this Prudential Standard provides for APRA to exercise a power or discretion, this power or discretion will be exercised in writing.

Responsibility for capital management

8. 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.

9. 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.

10. 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.

11. 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; and

    (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

12. 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.

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

14. 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 15 in respect of the ADI.

15. 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 16.

16. 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 15(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.

17. 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.

18. 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.

19. 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.

20. 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

21. 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 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

22. APRA will 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.

23. 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 determine higher PCRs for an ADI and may change an ADI's PCRs at any time.

24. 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

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

26. The capital conservation buffer is 2.5 per cent of the ADI's total risk-weighted assets, unless determined otherwise by APRA. 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.

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

28. 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;

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

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

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

29. 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

30. From 1 January 2016, APRA may require an ADI 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.

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

32. 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.

33. 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).

Leverage ratio

34. For the purposes of making the leverage ratio disclosures in *Prudential Standard APS 330 Public Disclosure,* an ADI with approval from APRA to use the **internal ratings-based (IRB) approach to credit risk** (IRB ADI) must determine its leverage ratio in accordance with Attachment D.

Reductions in capital

35. 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.

36. 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**

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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.

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.

37. 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.

38. 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

39. 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.

40. 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;

(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.

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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.

Adjustments and exclusions

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

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6 Refer to subsection 11AF(2) of the Banking 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 II and 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 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 $\leq$ (PCR + 0.25CB)	100
Within second quartile of buffer > (PCR + 0.25CB) to $\leq$ (PCR + 0.50CB)	80
Within third quartile of buffer > (PCR + 0.50CB) to $\leq$ (PCR + 0.75CB)	60
Within fourth quartile of buffer > (PCR + 0.75CB) to $\leq$ (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. An

ADI that does not have positive earnings and has a Common Equity Tier 1 Capital ratio less than the sum of its Common Equity Tier 1 PCR plus the capital conservation buffer must not make positive net distributions.

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 36(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 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.

Attachment D

Leverage ratio

1. An IRB ADI must calculate its leverage ratio as follows:

$$\textit{leverage ratio} = \frac{\textit{Tier 1 Capital}}{\textit{Exposure Measure}}$$

where:

(a) Tier 1 Capital is determined in accordance with APS 111; and

(b) the Exposure Measure is determined in accordance with paragraphs 3 to 29 of this Attachment.

2. The leverage ratio must be calculated on a Level 2 basis or, where a Level 2 basis is not applicable, on a Level 1 basis.

3. The exposure measure must follow Australian Accounting Standards, subject to the following:

(a) on-balance sheet, non-derivative exposures must be included in the exposure measure net of specific provisions or accounting valuation adjustments (e.g. accounting credit valuation adjustments);

(b) unless specified otherwise, an ADI must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the exposure measure; and

(c) netting of loans and deposits is not permitted.

4. An IRB ADI must calculate the exposure measure as the sum of:

(a) on-balance sheet exposures;

(b) derivatives exposures;

(c) securities financing transaction (SFT) exposures[7]; and

(d) other off-balance sheet exposures.

[7] For the purpose of calculating the leverage ratio as set out in this attachment, SFTs are transactions such as repurchase agreements, reverse repurchase agreements, and security lending and borrowing, and margin lending transactions, where the value of the transactions depends on the market valuation of securities and the transactions are typically subject to margin agreements.

On-balance sheet exposures

5. In determining its on-balance sheet exposures, an IRB ADI must apply the following treatments:

   (a) include all balance sheet assets, including on-balance sheet derivatives collateral and collateral for SFTs, with the exception of on-balance sheet derivatives and SFT assets that are covered in paragraphs 7 to 28 below;

   (b) balance sheet assets deducted from Common Equity Tier 1 Capital and Additional Tier 1 Capital for the purposes of regulatory adjustments under APS 111 must be deducted from the exposure measure; and

   (c) liability items must not be deducted.

6. Where an IRB ADI holds assets in a fiduciary capacity, these assets may be excluded from the exposure measure provided that the assets meet the accounting criteria for derecognition and, where applicable, the accounting criteria for deconsolidation.

Derivatives exposures

7. In determining its derivatives exposures, including where an IRB ADI sells protection using a credit derivative, an ADI must apply the treatments in paragraphs 8 to 20 of this Attachment.

Treatment of derivatives

8. The exposure of derivatives transactions covered by an eligible bilateral netting agreement is calculated according to paragraph 9 of this Attachment. For a single derivatives transaction not covered by an eligible bilateral netting agreement, the exposure is calculated according to paragraph 10 of this Attachment. For the purposes of this Attachment, an eligible bilateral netting agreement is one that meets the criteria in paragraphs 7 to 12 in Attachment J to APS 112[8]. Written credit derivatives are subject to an additional treatment, as set out in paragraphs 17 to 20 of this Attachment.

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[8] Cross-product netting (i.e. between derivatives and SFTs) is not permitted. Where an ADI has a cross-product netting agreement that meets the criteria of an eligible bilateral netting agreement, it may perform netting separately in each product category provided all other conditions for netting in this product category are met.

9. The exposure of transactions covered by an eligible bilateral netting agreement must be calculated as follows:

   $exposure\ measure = NRC$ (if positive) + $PFCE_{adj}$

   where

   NRC = the net mark-to-market replacement cost of all netted transactions. It is defined to be the same as the net current credit exposure (*NCCE*), and must be obtained according to paragraph 29 in Attachment J to APS 112; and

   $PFCE_{adj}$ is the gross potential future credit exposure add-on adjusted for netting. $PFCE_{adj}$ must be obtained according to paragraphs 30 to 35 in Attachment J to APS 112.

10. The exposure of a single derivatives transaction not covered by an eligible bilateral netting agreement must be calculated as follows:

    $exposure\ measure = RC$ (if positive) + $PFCE$

    where

    RC = the replacement cost of the agreement (obtained by marking to market), where the contract has a positive value; and

    PFCE = the potential future credit exposure add-on amount over the remaining life of the contract. *PFCE* must be obtained according to paragraphs 2, 4 to 8 and 10 to 11 in Attachment B to APS 112.

Treatment of related collateral

11. When calculating the exposure amount for derivatives by applying paragraphs 8 to 10 of this Attachment, an IRB ADI must not reduce the exposure amount by any *collateral received* from the counterparty.

12. An IRB ADI must gross up their exposure measure by the amount of any derivatives *collateral provided* notwithstanding that the provision of that collateral has reduced the value of its balance sheet assets under Australian Accounting Standards.

Treatment of cash variation margin

13. The following conditions must be met for the cash portion of variation margin exchanged between counterparties to be treated as a form of pre-settlement payment:

    (a) for trades not cleared through a qualifying central counterparty (QCCP)[9], the cash received by the recipient counterparty is not segregated;

[9] QCCP is defined in paragraph 9(x) of APS 112.

(b) variation margin is calculated and exchanged on a daily basis based on mark-to-market valuation of derivatives positions;

(c) the cash variation margin is received in the same currency as the currency of settlement of the derivatives contract;

(d) variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivatives subject to the threshold and minimum transfer amounts applicable to the counterparty; and

(e) derivatives transactions and variation margins are covered by a single master netting agreement (MNA)[10,11] between the legal entities that are the counterparties in the derivatives transaction. The MNA must explicitly stipulate that the counterparties agree to settle net any payment obligations covered by such a netting agreement, taking into account any variation margin received or provided if a credit event occurs involving either counterparty. The MNA must be legally enforceable and effective in all relevant jurisdictions, including in the event of default and bankruptcy or insolvency.

14. If the conditions in paragraph 13 are met, an IRB ADI may use the cash portion of its variation margin received to reduce the replacement cost portion of the leverage ratio exposure measure, and the receivables assets from cash variation margin provided may be deducted from the leverage ratio exposure measure as follows:

(a) if the ADI *receives* cash variation margin from a counterparty, it may reduce only the replacement cost portion[12] (i.e. *NRC* or *RC* defined in paragraphs 9 or 10 in this Attachment) of the exposure amount of the derivatives asset by the amount of cash received if the positive mark-to-market value of the derivatives contract(s) has not already been reduced by the same amount of cash variation margin received under Australian Accounting Standards; and

(b) if the ADI *provides* cash variation margin to a counterparty, it may deduct the resulting receivable from its leverage ratio exposure measure, where the cash variation margin has been recognised as an asset under Australian Accounting Standards.

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10 MNA is defined the same way as the bilateral netting agreement as set out in paragraphs 7 to 12 in Attachment J to APS 112, except that MNA in this case must also include any ‘netting agreement’ that provides legally enforceable rights of set-off.

11 A master MNA is a single MNA for this purpose.

12 Cash variation margin received must not be used to reduce the *PFCE* amount or either the numerator or the denominator of the net-to-gross ratio (*NGR*) as defined in paragraph 33 in Attachment J to APS 112.

Treatment of clearing services

15. When an IRB ADI acting as a clearing member[13] offers clearing services to clients, the ADI's trade exposures[14] to the central counterparty (CCP)[15] that arise when the clearing member is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults, must be captured by applying the same treatment that applies to any other type of derivatives transactions. When the ADI, based on the contractual arrangements with the client, is not required to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that a QCCP defaults, the clearing member must not include the resulting trade exposures to the QCCP in the leverage ratio exposure measure.

16. When a client enters directly into a derivatives transaction with the CCP, and a clearing member ADI guarantees the performance of its clients' derivatives trade exposures to the CCP, the ADI must calculate its related leverage ratio exposure resulting from the guarantee as a derivatives exposure as set out in paragraphs 8 to 14 of this Attachment, as if it had entered directly into the transaction with the client, including with regard to the receipt or provision of cash variation margin.

Additional treatment for written credit derivatives

17. In addition to the **CCR** exposure, written credit derivatives also create credit exposure to the underlying reference entity. It is appropriate to treat written credit derivatives consistently with cash instruments (e.g. loans, bonds) for the purposes of the exposure measure. The additional credit exposure must be calculated according to paragraphs 18 and 19 of this Attachment.

18. To capture the credit exposure to the underlying reference entity, the effective notional amount[16] referenced by a written credit derivative must be included in the exposure measure. The effective notional amount may then be reduced in one or both of the following ways:

    (a) by the negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital with respect to the written credit derivatives;

    (b) by the effective notional amount of an offsetting purchased credit derivatives on the same reference name[17,18], provided the conditions set out in paragraph 19 in this Attachment are satisfied.

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13 'Clearing member' is defined in paragraph 9(b) of APS 112.

14 For the purposes of paragraphs 15 and 16 of this Attachment, 'trade exposures' includes initial margin irrespective of whether or not it is posted in a manner that makes it remote from the insolvency of the CCP.

15 CCP is defined in paragraph 9(a) of APS 112.

16 The effective notional amount is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.

17 When an offsetting purchased credit derivatives transaction exists, the effective notional amount of a written credit derivative may be reduced by any negative change in fair value reflected in

19. The following conditions must be satisfied if an IRB ADI chooses to include the deduction on effective notional amount from the offsetting purchased credit derivatives as set out in paragraph 18(b):

    (a) the written and the offsetting purchased credit derivatives transactions must refer to the same legal entity;

    (b) the remaining maturity of the credit protection purchased is equal to or greater than the remaining maturity of the written credit derivatives;

    (c) for single name credit derivatives[19], the credit protection purchased must be on a reference obligation which ranks *pari passu* with, or is junior to, the underlying reference obligation of the written credit derivatives, and that a credit event on the senior reference asset must result in a credit event on the subordinated reference asset; and

    (d) if an ADI purchases protection on a pool of reference names, the protection purchased must be economically equivalent to buying protection separately on each of the individual names in the pool[20], and the pool of reference entities and the level of subordination in both transactions must be identical[21].

20. When the effective notional amount is included in the exposure measure as described in paragraph 18 of this Attachment, and the deduction of offsetting purchased credit derivatives is not included as described in paragraph (b), an IRB ADI may apply one of the following two deductions:

    (a) if an eligible bilateral netting contract is in place according to conditions set out in paragraph 8 of this Attachment, the ADI may deduct the individual *PFCE* add-on amount from $PFCE_{gross}$[22] , which is defined in 30 to 35 of Attachment J to APS 112; or,

    (b) when such a netting contract is not in place, the ADI may set the *PFCE* add-on amount, as defined in paragraph 10 in this Attachment, to zero.

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the ADI's Tier 1 Capital as described in subsection (a) of this paragraph, if the effective notional amount of the offsetting purchased credit protection is also reduced by any resulting positive change in fair value reflected in Tier 1 Capital.

18 When an ADI buys credit protection through a total return swap (TRS) and records the net payments received as net income, but does not record offsetting deterioration in the value of the written credit derivative (either through reductions in fair value or by an addition to reserves) reflected in Tier 1 Capital, the credit protection must not be recognised for the purpose of offsetting the effective notional amounts related to written credit derivatives.

19 For tranched products, the purchased protection must be on a reference obligation with the same level of seniority.

20 This would, for example, be the case if an ADI were to purchase protection on an entire securitisation structure.

21 If an IRB ADI purchases protection on a pool of reference names, but the credit protection does not cover the entire pool, then offsetting must not be included for the protection sold on individual reference names. However, such purchased protections may offset sold protections on a pool provided the purchased protection covers the entirety of the subset of the pool on which protection has been sold.

22 However, no adjustments must be made to *NGR*, which is defined in paragraph 33 in Attachment J of APS 112.

Securities financing transaction exposures

21. In determining its SFT exposures, an IRB ADI acting as a principal must apply the treatments in paragraphs 22 to 24 in this Attachment, while an IRB ADI acting as an agent must apply the treatments in paragraphs 26 to 28. For sale accounting transactions, an ADI must apply the treatment set out in paragraph 25 of this Attachment.

22. When an IRB ADI is acting as a principal, the leverage ratio exposure must include the sum of the following amounts:

    (a) gross SFT assets[23] recognised for accounting purposes (i.e. with no recognition of accounting netting),[24] adjusted as follows:

        (i) excluding the value of any securities received under an SFT, where the ADI has recognised the securities as an asset on its balance sheet; and

        (ii) cash payables and cash receivables in SFTs with the same counterparty may be measured net if all the following criteria are met:

            (A) transactions have the same explicit final settlement date;

            (B) the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both currently in the normal course of business and in the event of: (i) default; (ii) insolvency; and (iii) bankruptcy; and

            (C) the counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date. To achieve such equivalence, both transactions are settled through the same settlement system and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement.[25] The failure of any single securities transaction in the settlement mechanism should delay settlement of only the

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[23] For SFT assets subject to novation and cleared through QCCPs, 'gross SFT assets recognised for accounting purposes' are replaced by the final contractual exposure, given that pre-existing contracts have been replaced by new legal obligations through the novation process.

[24] Gross SFT assets recognised for accounting purposes must not recognise any *accounting* netting of cash payables against cash receivables.

[25] This ensures that any issues arising from the securities leg of the SFTs do not interfere with the completion of the net settlement of the cash receivables and payables.

matching cash leg or create an obligation to the settlement mechanism, supported by an associated credit facility;[26] and

(b) a measure of CCR calculated as the current exposure without a *PFCE* add-on, calculated as follows:

(i) where a qualifying MNA as defined in paragraphs 23 to 24 of this Attachment is in place, the current exposure (E^*) must be set to the greater of zero and the total fair value of securities and cash lent to a counterparty for all transactions included in the qualifying MNA ($\sum E_i$) less the total fair value of cash and securities received from the counterparty for those transactions ($\sum C_i$). This is illustrated in the following formula:

$$E^* = \max \{0, [\sum E_i - \sum C_i]\}$$

(ii) where no qualifying MNA is in place, the current exposure for transactions with a counterparty must be calculated on a transaction by transaction basis – that is, each transaction i is treated as its own netting set, as shown in the following formula:

$$E_i^* = \max \{0, [E_i - C_i]\}$$

23. A bilateral netting agreement for covering SFTs may be recognised as a qualifying MNA on a counterparty by counterparty basis only if it:

(a) is legally enforceable in each relevant jurisdiction upon the occurrence of an event of default, regardless of whether the counterparty is insolvent or bankrupt;

(b) provides the non-defaulting party with the right to terminate and close out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;

(c) provides for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other; and

(d) allows for the prompt liquidation or setoff of collateral in the event of default.

24. Netting across positions held in the banking book and trading book will only be recognised when the netted transactions fulfil the following conditions:

(a) all transactions are marked to market daily; and

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26 If there is a failure of the securities leg of a transaction in such a mechanism at the end of the window for settlement in the settlement mechanism, then this transaction and its matching cash leg must be split out from the netting set and treated gross for the purposes of the leverage ratio exposure measure.

(b) the collateral instruments used in the transactions are recognised as eligible financial collateral in the banking book.

25. Leverage may remain with the lender of the security in an SFT whether or not sale accounting is achieved under Australian Accounting Standards. As such, where sale accounting is achieved for an SFT under Australian Accounting Standards, the IRB ADI must reverse all sales-related accounting entries, and then calculate its exposure as if the SFT had been treated as a financing transaction under those standards (i.e. the ADI must include the sum of amounts in subparagraphs 22(a) and 22(b) of this Attachment for such an SFT) for the purposes of determining its exposure measure.

26. When an IRB ADI acting as an agent in an SFT provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided, the ADI must calculate its exposure measure by applying only subparagraph 22(b) in this Attachment.

27. An IRB ADI is eligible to apply the exceptional treatment set out in paragraph 26 in this attachment only if the ADI's exposure to the transaction is limited to the guaranteed difference between the value of the security or cash its customer has lent and the value of the collateral the borrower has provided. Where the ADI does not own/control the underlying cash or security resource, that resource cannot be leveraged by the ADI. In situations where the ADI is further economically exposed (i.e. beyond the guarantee for the difference) to the underlying security or cash in the transaction,[27] a further exposure equal to the full amount of the security or cash must be included in the exposure measure.

28. When an IRB ADI acting as agent in an SFT does not provide an indemnity or guarantee to any of the involved parties, the ADI has no exposure to the SFT, and must set the exposure measure of those SFTs to zero.

Other off-balance sheet exposures

29. To determine other off-balance sheet exposures for the purposes of the leverage ratio, an IRB ADI must apply credit conversion factors (CCFs) to the gross notional amounts of off-balance sheet items as follows:

(a) commitments other than securitisation liquidity facilities with an original maturity up to one year and commitments with an original maturity over one year must receive a CCF of 20 per cent and 50 per cent, respectively. However, any commitments that are unconditionally cancellable at any time by the ADI without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, will receive a CCF of 10 per cent;

(b) direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and

27 For example, due to the ADI managing collateral received in the ADI's name or on its own account rather than on the customer's or borrower's account (e.g. by on-lending or managing unsegregated collateral, cash or securities).

securities) and acceptances (including endorsements with the character of acceptances) must receive a CCF of 100 per cent;

(c) forward asset purchases, forward forward deposits and partly paid shares and securities, which represent commitments with certain drawdown, must receive a CCF of 100 per cent;

(d) certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) must receive a CCF of 50 per cent;

(e) note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) must receive a CCF of 50 per cent;

(f) for short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment), a CCF of 20 per cent must be applied to both issuing and confirming ADIs;

(g) where there is an undertaking to provide a commitment on an off-balance sheet item, ADIs are to apply the lower of the two applicable CCFs; and

(h) off-balance sheet securitisation exposures, except an eligible liquidity facility or an eligible servicer cash advance facility as set out in Attachment E to *Prudential Standard APS 120 Securitisation*, must receive a CCF of 100 per cent. Eligible liquidity facilities must receive a CCF of 50 per cent and undrawn service cash advances or facilities that are unconditionally cancellable without prior notice must receive a 10 per cent CCF.