AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

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To: All locally incorporated authorised deposit-taking institutions (ADIs) other than purchased payment facility providers

Re: Response to submissions on draft *Prudential Practice Guide APG 110 Capital Buffers*

On 17 December 2015, the Australian Prudential Regulation Authority (APRA) released for consultation a draft *Prudential Practice Guide APG 110 Capital Buffers* (APG 110). APRA received one submission, from an industry association, and this letter outlines APRA's response to issues raised in the submission.

Capital conservation buffer

Operation of constraints on capital distributions

The key issue raised in the submission concerned the ability of an ADI to make Additional Tier 1 (AT1) capital distributions when its Common Equity Tier 1 (CET1) capital ratio falls within the capital buffer range. An example was given whereby after paying an ordinary dividend, an ADI experiences a decline in earnings which limits its ability to pay an upcoming AT1 capital distribution. It was argued that an automatic restriction on AT1 capital distributions is undesirable as it could result in a loss of confidence in the ADI and adversely impact the demand for its capital instruments, particularly at a time when additional capital may be needed. It was also asserted that automatic restriction of such payments removes the discretion of an ADI to prioritise and determine which distributions it will pay when it is in the capital buffer range. The submission suggested that using the profits test definition of earnings[1] in *Prudential Standard APS 110 Capital Adequacy* (APS 110) would alleviate this problem as it would align distributions with the financial year to which they relate.

APRA's intention is that the constraints on distributions act to ensure that once an ADI is within the capital buffer range its capital position is restored in a timely manner. As detailed in paragraph 29 of APS 110, an ADI may apply to APRA to make payments in excess of the constraints imposed by the capital conservation buffer regime. In considering whether to approve such an application, APRA would expect an ADI to demonstrate that it has a capital plan that details the measures the ADI will take to raise capital equal to or greater than the amount above the constraint that the ADI wishes to distribute. In the absence of APRA's

[1] Footnote 5 of *Prudential Standard APS 110 Capital Adequacy* (APS 110) states that a '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.

approval of such a capital plan an ADI's distributions would be constrained. APRA has made amendments to APG 110 to clarify its intention.

The submission also raised concerns about estimating earnings outside normal reporting cycles and the potential complexity and costs associated with doing so. In this regard, APRA is not requiring an ADI to seek formal review or audit of financial information outside the normal reporting cycle but rather to determine a robust internal estimate of earnings as close as possible to the date of the distribution in question. APRA has made minor drafting changes to APG 110 to better reflect this.

Consistency of capital distributions

The submission stated that APS 110 requires earnings to be calculated prior to the deduction of items that are distributions for capital conservation buffer purposes, but is silent on whether such items should also be added back to CET1 capital for the purposes of determining the ADI's CET1 capital ratio. It was argued that this leads to an inconsistent treatment for AT1 instruments treated as debt or equity securities for accounting purposes. In the case of AT1 instruments classified as debt securities, coupon payments are regularly accrued through profit and loss (and hence deducted from CET1 capital) but for coupon payments on AT1 instruments treated as equity securities, the coupon payment is only charged to profit and loss (and hence deducted from CET1 capital) when the coupon payment is declared.

APRA agrees with the analysis of different outcomes depending on the exact nature of an AT1 instrument; however, in APRA's view the position as set out in APS 110 (to allow earnings to be calculated prior to the deduction of distributions, but make no corresponding adjustment to CET1 capital) is prudent and appropriate. APRA considers this position is consistent with the international framework set out by the Basel Committee on Banking Supervision (Basel Committee) and is consistent with the treatment of such items in a number of other jurisdictions.

Discretionary bonus payments to staff

The submission requested that APRA provide guidance on the treatment of discretionary bonus payments to staff, in the form of on-market purchase of an ADI's shares, which are accrued but not paid until a future date.

Once awarded, bonus payments to staff in the form of equity are generally required to be paid subject only to certain criteria agreed by the ADI and staff member that must be met before the payment vests in a staff member's name. Therefore, once a payment is awarded it is a declared distribution and from that point on is no longer discretionary. Consistent with paragraph 25 of *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*, such items must be deducted from CET1 capital where the payment will involve an on-market purchase of shares to settle the obligation.

<u>Countercyclical capital buffer</u>

Materiality threshold for disclosure purposes

The submission asked APRA to consider applying a materiality threshold to the countercyclical capital buffer Pillar 3 disclosure requirements. APRA confirms that the materiality provision in paragraph 55 of *Prudential Standard APS 330 Public Disclosure* applies to these disclosures. APG 110 has been amended to explicitly refer to this provision.

Jurisdictional reciprocity

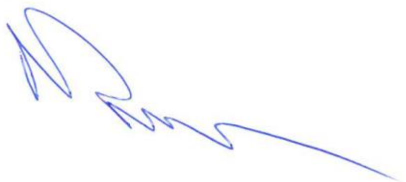
Guidance was sought on the treatment of countercyclical capital buffer requirements in other jurisdictions where these differ from the Basel Committee's requirements. For example, the submission sought guidance on the treatment of the buffer requirements in Sweden, which is above the minimum transitional provisions of the Basel framework. APRA confirms that an ADI is required to apply the requirements in place in the jurisdiction in which it has private sector credit exposures, even where these are above the minimum measures set out in the Basel framework. APG 110 has been amended to make this clear.

Overseas branches

The submission also sought clarification on whether certain exemptions from the need to apply overseas requirements at Level 2 also apply at Level 1. APRA confirms that these exemptions also apply at Level 1 (e.g. an ADI with a branch operation in a jurisdiction with a sector-specific countercyclical buffer is not required to apply that buffer). APG 110 has been amended accordingly.

APRA has released the revised final version of APG 110 with amendments as set out in this letter. APG 110 can be found at:
http://www.apra.gov.au/adi/PrudentialFramework/Pages/authorised-deposit-taking-institutions-ppgs.aspx.

Yours sincerely



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