AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
1 Martin Place (Level 12), Sydney, NSW 2000
GPO Box 9836, Sydney, NSW 2001

T 02 9210 3000 | W www.apra.gov.au

WAYNE BYRES
APRA Chairman

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TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

CAPITAL MANAGEMENT

In April 2020, APRA provided guidance to all authorised deposit-taking institutions (ADIs) on capital management. This included an expectation that Boards would seriously consider deferring decisions on dividends given the uncertainty in the economic outlook, and would offset any distributions to the extent possible through other capital actions.

As the industry moves beyond the initial phase of the COVID-19 response, APRA is today providing updated guidance on capital management. The aim of this guidance is to assist longer-term capital planning and to ensure ADIs remain able to fulfil their role in supporting Australia's economic recovery.

Banking system resilience

Over the past three months, APRA has assessed the banking industry's resilience to a range of stress scenarios. With significant uncertainty over the depth and duration of the economic impact from COVID-19, APRA's objective has been to test the industry's ability to withstand stress of different magnitudes.

From this stress testing, it is clear that the banking system overall is well positioned to withstand a severe downturn, but also that it would be severely impacted if such a scenario unfolded. There is, therefore, a need for continued vigilance and careful planning: there remains uncertainty in the outlook both domestically and internationally; there is always a margin for error in any forward-looking analysis; and stress test results for individual banks will inevitably vary from the average.

Industry guidance

In this context, it is important that banks manage their capital capacity prudently, moderating dividend payments to sustainable levels and prioritising lending to support households and businesses during the economic recovery. In addition, banks will need to navigate the challenges ahead in managing a material volume of loans on repayment deferrals, supporting borrowers in an orderly transition.

APRA is therefore providing further guidance on capital planning for ADIs for the period ahead:

- *Buffers are available to be used if needed:* As announced in March 2020, APRA does not expect ADIs to meet the unquestionably strong capital benchmarks in the period ahead. ADIs are free to, and should, make use of management buffers held above minimum regulatory requirements to absorb the impacts of stress if needed, and continue to lend to support households and businesses. The capital conservation buffer (CCB) provides an additional layer of capital that is available to be used if conditions deteriorate markedly.

- *Caution should be maintained on dividends:* To maintain caution in the face of ongoing uncertainty and heightened economic risk, ADIs should continue to take a measured approach to capital distributions. For 2020, APRA expects ADIs will retain at least half of their earnings, and actively use dividend reinvestment plans (DRPs) and/or other capital management initiatives to at least partially offset the diminution in capital from distributions.

- *Stress testing should be conducted regularly to guide decision-making:* ADIs should use stress testing to inform decisions on dividends and other capital actions, as well as to assess their lending capacity under a range of different scenarios. ADIs should build positive loan growth assumptions into capital projections and stress testing to test and demonstrate the capacity to continue to lend: reductions in credit supply should not be relied upon to meet internal stress testing benchmarks.[1]

- *Plans for any capital rebuild should be orderly:* ADIs should plan on the basis of an orderly rebuild in capital levels, where needed. APRA is committed to ensuring any rebuild of capital buffers, if required, will be conducted in a gradual manner. APRA notes that the implementation of the Basel III capital reforms, which will embed the ‘unquestionably strong’ level of capital in the framework, has been postponed to 1 January 2023.

APRA’s approach on the use of buffers is consistent with recent statements by the Basel Committee (17 June 2020) and the Financial Stability Board (15 July 2020). In particular, the Basel Committee noted that using capital resources to support the real economy and absorb losses should take priority at present.

Next steps

APRA expects that all ADIs will embed the principles above in their capital management for the period ahead. This should include regular review of capital buffers and targets, prudent decisions on dividends and ongoing stress testing to forecast and plan capital levels.

If you have any questions on the above guidance, please contact your responsible supervisor.

Yours sincerely,

Wayne Byres
Chair

[1] While these internal benchmarks are for ADIs to determine, Boards should ensure that they reflect clear tolerances that are consistent with their risk appetite given the severity of the scenario.