PRUDENTIAL PRACTICE GUIDE

Draft APG 110 Capital Adequacy

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Contents

About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

Prudential Standard APS 110 Capital Adequacy (APS 110) sets out APRA's requirements for capital adequacy for authorised deposit-taking institutions (ADIs). This PPG, *Prudential Practice Guide APG 110 Capital Adequacy* (APG 110), aims to assist ADIs in complying with those requirements.

This PPG should be read in conjunction with APS 110 and *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110), as well as APRA's other prudential standards and associated guidance for ADI capital. Not all of the practices outlined in this PPG will be relevant for every ADI, and some aspects may vary depending upon the size, complexity and risk profile of the institution.

Glossary

ADI	Authorised deposit-taking institution as defined in the *Banking Act 1959.*
APS 001	*Prudential Standard APS 001 Definitions*
APS 110	*Prudential Standard APS 110 Capital Adequacy*
APS 112	*Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
APS 113	*Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*
APS 115	*Prudential Standard APS 115 Capital Adequacy: Standardised Measurement Approach to Operational RIsk*
APS 116	*Prudential Standard APS 116 Capital Adequacy: Market Risk*
APS 120	*Prudential Standard APS 120 Securitisation*
APS 180	*Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk*
APS 330	*Prudential Standard APS 330 Public Disclosure*
Basel Committee	Basel Committee on Banking Supervision
Board	Board of directors
CCB	Capital conservation buffer
CCyB	Countercyclical capital buffer
CPG 110	*Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review*
D-SIB	An ADI that has been determined by APRA to be a domestic systemically important bank.
IRB ADI	An ADI which has been approved by APRA to use the internal ratings-based (IRB) approach to credit risk.
Non-SFI	Non-significant financial institution, as defined in APS 001.
Prudential capital requirement (PCR)	The minimum amount of Regulatory Capital that an ADI or NOHC must hold, as defined in APS 110. Eligible Regulatory Capital is defined in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital.*
Risk-weighted assets (RWA)	Determined in accordance with the relevant requirements of Attachment A to APS 110.

SA-CCR	Standardised approach to counterparty credit risk
SFI	Significant financial institution, as defined in APS 001.
Standardised ADI	An ADI which has not been approved by APRA to use the internal ratings-based approach to credit risk.

Introduction

1. APS 110 sets out APRA's requirements for capital adequacy for ADIs. Under APS 110, ADIs must maintain adequate capital for the risks associated with their activities. The ultimate responsibility for the prudent management of capital rests with the ADI's Board.

2. This PPG provides guidance to assist ADIs in meeting the requirements of APS 110. It focuses on key aspects of the standard that are specific to ADIs: the operation of capital buffers, the countercyclical capital buffer, simplified requirements for small ADIs, the IRB capital floor and the leverage ratio.

3. This PPG should be read in conjunction with CPG 110, which provides Boards, senior management and other key stakeholders with broader guidance on capital management. CPG 110 focuses on the internal capital adequacy assessment process (ICAAP) and APRA's supervisory review process for capital.

4. This PPG should also be read in conjunction with APRA's other prudential standards and guidance for ADI capital management, where relevant. A summary of these is set out in Table 1 below.

Table 1. ***APRA capital standards***

Standards	APRA code	Covers
Capital adequacy	APS 110	Capital adequacy: overarching requirements for maintaining capital adequacy and for capital management
Capital definitions	APS 111	Measurement of capital: criteria for measuring an ADI's regulatory capital, specifically the criteria that capital instruments must meet to qualify as Common Equity Tier 1 capital, Additional Tier 1 or Tier 2 capital
Credit risk	APS 112, APS 120, APS 180	Standardised approach to credit risk: measurement of credit risk capital requirements based on standardised risk weights, with associated capital requirements for securitisation and counterparty credit risk exposures
Credit risk modelling	APS 113	Internal ratings-based approach to credit risk: measurement of credit risk capital requirements based on advanced internal models
Operational risk	APS 115	Standardised measurement approach to operational risk: measurement of operational risk capital requirements

Standards	APRA code	Covers
Market risk	APS 116, APS 117	Market risk: measurement of capital requirements for market risk and, for advanced ADIs, interest rate risk in the banking book

Chapter 1 - Capital management

This section provides guidance on APS 110 paragraphs 23-45, and Attachment B.

Minimum capital requirements

5. ADIs are subject to minimum prudential capital requirements (PCRs) under APS 110, as set out in Table 2. Minimum PCRs are set for different tiers of capital, namely Common Equity Tier 1 Capital (CET 1), Tier 1 Capital and Total Capital.

Table 2. ***Minimum prudential capital requirements (PCR)***

Minimum requirements	Standardised	IRB	D-SIB
CET 1	4.5%	4.5%	4.5%
Tier 1	6%	6%	6%
Total Capital	8%	8%	8%

6. ADIs must maintain capital ratios above PCRs at all times. As required under APS 110 (paragraph 45), ADIs must inform APRA as soon as practicable where there are any significant departures from their ICAAPs, concerns about capital adequacy (including projected losses), or indications of significant adverse changes in market pricing.

7. Under APS 110 (paragraph 24), APRA may determine a higher PCR for an ADI at any time. Further detail on the process for any 'Pillar 2' supervisory adjustments to PCRs is set out in CPG 110.[1] There are a range of circumstances in which an adjustment may be required, including, but not limited to, where:

    a) capital requirements under the prudential standards do not fully address risks specific to the entity, such as strategic risk, reputation risk, concentration risk or other risks;

    b) an entity has a higher risk business model or complex organisational structure, is newly licensed, or is making material changes to business mix; or

    c) there are material concerns regarding weaknesses in governance or risk management, a failure to comply with prudential standards or inadequacies in capital management.

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[1] The Basel Committee's framework for capital rests on three pillars. 'Pillar 1' is quantitative requirements for capital as set out in the prudential standards and measured in risk-weighted asset (RWA) terms. 'Pillar 2' is the supervisory review process, which includes supervision of risk management and may include adjustments to capital requirements. 'Pillar 3' is disclosure requirements designed to encourage market discipline.

8. APRA may also adjust an ADI's PCR to ensure that there is sufficient loss-absorbing capacity for resolution. This would typically be implemented through an adjustment to an ADI's Total Capital PCR.

9. An ADI must not disclose its individual PCR ratios, as required by APS 110 (paragraph 24). This approach is consistent across all ADIs, as disclosure by one may create pressure for disclosure by others. It is intended to manage the risk that disclosure could result in unintended or incorrect signalling, leading to financial instability at one or more ADIs.

10. A prudent ADI would discuss with APRA whether, and if so how, to disclose any material ~~APRA-determined supervisory~~ adjustments to 'Pillar 1' risk-weighted assets (RWA) requirements~~, such as supervisory overlays,~~ in public financial and regulatory reporting. If disclosed, good practice would be to clearly identify and explain the ~~supervisory~~ adjustment, including any associated corrective action being undertaken.

Reductions in capital

11. Under APS 110 (paragraph 40), an ADI must obtain APRA's prior approval for any planned reduction in capital including a share buyback or where the aggregate amount of dividend payments on ordinary shares exceeds statutory after-tax earnings ('the profits test'). APRA's approval is required for a reduction in capital even in circumstances where there is a subsequent offsetting benefit to capital adequacy, such as the write-off of intangible items which may reduce CET 1 deductions.

12. An ADI proposing a reduction in capital must provide APRA with a forecast of its capital position extending for at least two years, as required by APS 110 (paragraph 42). Such a forecast would ideally include:

    a) capital projections at all tiers of capital;

    b) supporting assumptions on the economic outlook, profitability, growth and other movements in RWA; and

    c) the results of recent stress testing, demonstrating that capital would remain adequate in adverse conditions after the proposed reduction.

13. Although decisions to reduce capital can be time sensitive, a prudent ADI would ensure it allowed sufficient time for the supervisory review of the proposal in its planning.

Regulatory capital buffers and management targets

14. ADIs are required to hold regulatory capital buffers above minimum CET 1 requirements, as set out in Table 3. There are three types of regulatory capital buffer: the capital conservation buffer (CCB), the additional CCB for domestic systemically important banks

(D-SIB), and the countercyclical capital buffer (CCyB).[2] The regulatory capital buffer range is the sum of these regulatory capital buffers.

Table 3. *Regulatory capital buffers*

CET 1 (% RWA)	Standardised	IRB	D-SIB
Minimum PCR (refer Table 2)	4.50%	4.50%	4.50%
CCB	2.50%	3.75%	3.75%
Additional CCB for D-SIBs	-	-	1.00%
CCyB	1.00%	1.00%	1.00%
Total	**8.00%**	**9.25%**	**10.25%**

Note: the CCyB may be set within a range of 0 - 3.5 per cent of RWA, with a baseline level of 1.0 per cent

15. ADIs must have sufficient CET 1 to meet the regulatory capital buffer requirement, and cannot double-count for this purpose any amount of CET 1 that is already being used to meet minimum requirements for Tier 1 and Total Capital.[3]

16. APRA may also determine a PCR, CCB or CCyB expressed as a dollar amount, rather than, or in addition to, a ratio to RWA. This may be adopted, for example, in the early stages after licensing a new ADI.

17. A prudent ADI, in seeking to remain above minimum regulatory capital requirements, would set their own management targets for all tiers of capital. These management targets would typically be defined as a range to account for significant events that impact the level of an ADI's capital, such as dividend payments. A prudent ADI would ensure it maintains a management target that is adequately:

    a) in excess of regulatory capital buffers in stable operating conditions, to allow for business growth, volatility in RWA, profit and capital surplus, and dividend policy; and

    b) sufficient to allow the ADI to withstand a severe but plausible downturn with capital ratios that remain above its PCR, calibrated based on regular stress testing.

18. APRA does not consider an ADI's management target in the same manner as a regulatory minimum or buffer. For example, no constraints on distributions are placed

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[2] Refer to APRA's Information Paper, *Domestic systemically important banks in Australia* (December 2013): https://www.apra.gov.au/news-and-publications/apra-releases-framework-for-domestic-systemically-important-banks-australia.

[3] For example, an ADI with a minimum CET 1 of 4.5% and minimum Tier 1 of 6.0% would typically hold Additional Tier 1 (AT1) capital instruments of 1.5%. If this ADI only held AT1 of 1.0%, then it would need 0.5% in CET 1 to meet Tier 1 requirements, and 5.0% (4.5% + 0.5%) of its CET 1 would not be eligible to be used to meet the CCB requirement.

on an ADI for falling below its management target range, unlike if its capital ratio entered a regulatory capital buffer.

19. In the example below (based on an ADI deemed to be a D-SIB), the ADI operates with a management target range of 11.0 - 11.5 per cent, based on its average target level of 100 basis points above its PCR and regulatory capital buffers. APRA would not expect this ADI to set another buffer on top of the average target level of 11.25 per cent to avoid falling below it. However, a prudent ADI would have a good understanding of the steps it would take to return to its management target range if it fell below it.

Figure 1. Example of setting a management target at a D-SIB

10.25%	11.25% target on average	11.0 – 11.5% target range
PCR and regulatory capital buffers	For example, target is 100 basis points above regulatory capital buffers based on factors such as stress	For example, 50 basis point range around average to account for volatility, such as from dividends

Use of regulatory capital buffers in stress

20. APRA expects that an ADI would not normally operate with its capital ratio in the regulatory capital buffer range during stable conditions. Nor would APRA expect an ADI to make a discretionary distribution that takes its capital ratios into the buffer range.

21. An ADI may, however, operate with capital ratios within the regulatory capital buffer range during periods of stress, either idiosyncratic to itself or during a systemic stress event. Doing so is not a breach of prudential requirements. The regulatory capital buffers are designed to ensure that an ADI can absorb the impact of losses and continue to lend during periods of stress, without jeopardising the interests of depositors.[4]

22. It may not be possible or desirable for an ADI to operate with capital ratios within its management target range in a severe stress scenario. Especially in a systemic stress event, it is important that ADIs make use of the flexibility provided by the regulatory capital buffers to continue to lend to support households and businesses during periods of stress, rather than seek to unnecessarily conserve capital by restricting credit supply.

23. An illustration of how buffers may be used in a stress scenario is presented below, including a capital rebuild path that would be agreed with APRA. In such circumstances,

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[4] Buffers also accommodate changes in capital ratios from procyclicality in RWA. APRA expects that IRB ADIs would aim to avoid excessive procyclicality by, for example, adopting a through-the-cycle rating philosophy and modifying inputs in credit rating systems to remove excessive volatility. Further guidance on this is provided in APG 113.