Prudential Standard APS 115

Capital Adequacy: Standardised Measurement Approach to Operational Risk

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires an authorised deposit-taking institution to hold sufficient regulatory capital against its operational risk exposures.

The key requirement of this Prudential Standard is that an authorised deposit-taking institution that is not subject to the simplified framework must calculate its capital requirement for operational risk based on its business indicator, a financial statement-based proxy of its operational risk exposure.

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Authority

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

Application

2. This Prudential Standard applies to **authorised deposit-taking institutions** (**ADIs**) except:

   (a) **foreign ADIs**;

   (b) **purchased payment facility providers** (**PPF providers**); and

   (c) ADIs which satisfy the eligibility criteria for the simplified framework.

3. A reference to an ADI in this Prudential Standard 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.

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

   (a) the holding company for a group, 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.

5. This Prudential Standard commences on 1 January 2021. However, for ADIs which do not have APRA's approval to use an advanced measurement approach to operational risk under *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* on 31 December 2020, this Prudential Standard commences on 1 January 2022.

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, the power or discretion is to be exercised in writing.

8. In this Prudential Standard, unless the contrary intention appears, a reference to an Act, Regulations or Prudential Standard is a reference to the Act, Regulations or Prudential Standard as in force from time to time.

Scope

9. This Prudential Standard applies to all operations and activities of an ADI.

Adjustments and exclusions

10. APRA may adjust or exclude a specific prudential requirement in this Prudential Standard in relation to one or more specified ADIs, authorised NOHCs or subsidiaries of an ADI or authorised NOHC.

11. APRA may require an ADI to reduce its level of **operational risk** or increase its capital if APRA considers that the ADI's **Regulatory Capital** for its operational risk exposure is not commensurate with the ADI's operational risk profile.

Previous exercise of discretion

12. An ADI must contact APRA if it seeks to place reliance, for the purposes of complying with this Prudential Standard, on a previous exemption or other exercise of discretion by APRA under a previous version of this Prudential Standard.

Calculation of operational risk regulatory capital

13. An ADI must calculate its operational risk capital charge as 12 per cent of its business indicator (BI), plus:

    (a) if the BI exceeds $1.5 billion, then 3 per cent of the amount by which the BI exceeds $1.5 billion, plus

    (b) if the BI exceeds $45 billion, then 3 per cent of the amount by which the BI exceeds $45 billion.

Calculation of the business indicator

14. An ADI must calculate its BI as set out in paragraphs 15 to 22 of this Prudential Standard.

15. The BI is calculated as follows:

$$BI = ILDC + SC + FC$$

where:

interest, leases and dividend component (ILDC) = the lesser of the interest component (as defined in paragraph 16) and the asset component (as defined in paragraph 17) plus the dividend component (as defined in paragraph 18); and

services component (SC) = the sum of the other operating component (as defined in paragraph 19) and the fee and commission component (as defined in paragraph 20); and

financial component (FC) = the sum of the trading book component (as defined in paragraph 21) and the banking book component (as defined in paragraph 22).

16. For the purposes of paragraph 15 of this Prudential Standard, an ADI's interest component is the annual average value over the most recent three years of the absolute value of the following calculation:

    (a) the ADI's interest income from all financial assets and other interest income, including interest income from finance and operating leases and profits from leased assets, less

    (b) the ADI's interest expenses from all financial liabilities and other interest expenses, including interest expense from finance and operating leases, losses, depreciation and impairment of operating leased assets.

17. For the purposes of paragraph 15 of this Prudential Standard, an ADI's asset component is 2.25 per cent times the average value over the most recent three years of the sum of the ADI's total gross outstanding loans (including non-performing loans), advances, interest bearing securities (including government bonds) and lease assets, measured at the end of each financial year.

18. For the purposes of paragraph 15 of this Prudential Standard, an ADI's dividend component is the annual average over the most recent three years of the ADI's dividend income from investments in stocks and funds not consolidated in the ADI's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures.

19. For the purposes of paragraph 15 of this Prudential Standard, an ADI's other operating component is the maximum of:

    (a) the annual average over the most recent three years of the ADI's other operating income and income not included in other BI components calculated according to paragraphs 15 to 22 of this Prudential Standard,[1] and

    (b) the annual average over the most recent three years of the ADI's other operating expenses and expenses not included in other BI components calculated in accordance with paragraphs 15 to 22 of this Prudential Standard.[2]

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[1] For the avoidance of doubt, this item includes gains from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations (refer to Australian Accounting Standards). However, this item does not include income from operating or finance leases, which are instead treated as interest income under paragraph16(a).

[2] For the avoidance of doubt, this item includes operational loss events and losses from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations (refer to Australian Accounting Standards). However, this item does not include expenses from operating or finance leases, which are instead treated as interest expenses under paragraph16(b).

20. For the purposes of paragraph 15 of this Prudential Standard, an ADI's fee and commission component is the maximum of:

    (a) the annual average over the most recent three years of the ADI's fee and commission income;[3] and

    (b) the annual average over the most recent three years of the ADI's fee and commission expenses.[4]

21. For the purposes of paragraph 15 of this Prudential Standard, an ADI's trading book component is the annual average over the most recent three years of the absolute value of the net profit (loss) on the ADI's trading book.[5] This includes the net profit (loss) on trading assets and trading liabilities, hedge accounting and exchange differences.

22. For the purposes of paragraph 15 of this Prudential Standard, an ADI's banking book component is the annual average over the most recent three years of the absolute value of the net profit (loss) on the ADI's banking book.[6] This includes the net profit (loss) on financial assets and liabilities measured at fair value through profit or loss, hedge accounting and exchange differences and realised gains (losses) on financial assets and liabilities not measured at fair value through profit or loss.

23. For the avoidance of doubt, an ADI must not include the following items in the calculation of a component of the BI in paragraphs 15 to 22 of this Prudential Standard:

    (a) income and expenses from insurance or reinsurance businesses;

    (b) premiums paid and reimbursements/payments received from insurance or reinsurance policies purchased;

    (c) administrative expenses, including staff expenses, outsourcing fees paid for the supply of non-financial services (e.g. logistical, information technology, or human resources services) and other administrative expenses, (e.g. expenses related to information technology, utilities, telephone, travel, office supplies, or postage);

    (d) recovery of administrative expenses including recovery of payments on behalf of customers (e.g. taxes debited to customers);

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3 For the avoidance of doubt, this includes income received by the ADI for providing advice and services and as an outsourcer of financial services.

4 For the avoidance of doubt, this includes outsourcing fees paid by the ADI for the supply of financial services, but not outsourcing fees paid for the supply of non-financial services such as logistical, information technology or human resources services (which are instead included in the calculation of the other operating component in paragraph 19 of this Prudential Standard).

5 An ADI's trading book has the meaning given in *Prudential Standard APS 116 Capital Adequacy: Market Risk*.

6 An ADI's banking book has the meaning given in *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*.

(e) expenses of premises and fixed assets, except when these expenses result from operational loss events;

(f) depreciation/amortisation of tangible and intangible assets, except depreciation/amortisation related to lease assets, which should be included in finance and operating lease expenses;

(g) provisions or reversal of provisions (e.g. on pensions, commitments and guarantees given), except provisions related to operational loss events;

(h) expenses due to share capital repayable on demand;

(i) impairment or reversal of impairment (e.g. on financial assets, non-financial assets, investments in subsidiaries, joint ventures and associates);

(j) changes in goodwill recognised in profit or loss; or

(k) corporate income tax (tax based on profits including current tax and deferred tax).

24. An ADI must base the calculations in paragraphs 15 to 22 of this Prudential Standard on the most recent three years of its audited year-end financial statements. Where an ADI does not have audited financial statements from each of the previous three years (e.g. in the case of an ADI in the early years of its operation), it must obtain APRA's approval to use an alternative calculation methodology.

25. In the event of a merger or acquisition, an ADI must use aggregated values when calculating the BI as set out in paragraphs 15 to 22 of this Prudential Standard, unless otherwise approved by APRA.

26. Subject to APRA's approval, an ADI may exclude divested activities when calculating the BI as set out in paragraphs 15 to 22 of this Prudential Standard.