



# Draft Prudential Practice Guide

## **CPG 110 – Internal Capital Adequacy Assessment Process and Supervisory Review**

August 2014


## Disclaimer and copyright

This prudential practice guide is not legal advice and users are encouraged to obtain professional advice about the application of any legislation or prudential standard relevant to their particular circumstances and to exercise their own skill and care in relation to any material contained in this guide.

APRA disclaims any liability for any loss or damage arising out of any use of this prudential practice guide.

© Australian Prudential Regulation Authority (APRA)

This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0).

 This licence allows you to copy, distribute and adapt this work, provided you attribute the work and do not suggest that APRA endorses you or your work. To view a full copy of the terms of this licence, visit [www.creativecommons.org/licenses/by/3.0/au/](http://www.creativecommons.org/licenses/by/3.0/au/).

## 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.

This PPG aims to assist regulated institutions in developing their Internal Capital Adequacy Assessment Process (ICAAP), including the required documentation, and in understanding the Australian Prudential Regulation Authority's (APRA's) approach to the supervisory review process for setting supervisory adjustments to required capital. The information in this guide supports compliance with *Prudential Standard APS 110 Capital Adequacy* (APS 110), *Prudential Standard GPS 110 Capital Adequacy* (GPS 110), *Prudential Standard LPS 110 Capital Adequacy* (LPS 110) and *Prudential Standard 3PS 110 Capital Adequacy* (3PS 110). These prudential standards set out requirements in relation to the capital adequacy of a regulated institution, including the need for a regulated institution to have an ICAAP, and establish a framework for supervisory review and adjustment of a regulated institution's capital requirements.

In this PPG, the term 'capital standards' is used to refer to APS 110, GPS 110, LPS 110 and 3PS 110, unless otherwise indicated. The term 'regulated institution' is used to refer to an authorised deposit-taking institution (ADI) on a Level 1 basis or a group of which an ADI is a member on a Level 2 basis, a general insurer or Level 2 insurance group, a life company (including a friendly society), or a Level 3 group. Where 'regulated institution' refers to a Level 2 group or a Level 3 group, 'Board' refers to the Board of directors of the institution that heads the group.

This PPG is designed to be read together with the capital standards and does not address all prudential requirements in relation to ICAAPs.

Subject to meeting the capital standards, regulated institutions have the flexibility to configure their approach to capital management in a manner best suited to achieving their business objectives. Not all of the practices outlined in this PPG will be relevant for every regulated institution and some aspects may vary depending upon the size, complexity and risk profile of the institution.

# Contents

<b>Part A – Internal Capital Adequacy Assessment Process</b>	<b>5</b>
<b>Board ownership of the ICAAP</b>	<b>5</b>
<b>Risk appetite and risk management framework</b>	<b>5</b>
<b>Requirements for the ICAAP</b>	<b>5</b>
Risk coverage	6
Proportionality	6
Forward-looking capital management	6
Group ICAAP considerations	6
Documenting the ICAAP	7
<b>Setting the target levels of capital</b>	<b>7</b>
<b>Strategy for maintaining adequate capital over time</b>	<b>8</b>
<b>Trigger levels and related actions to manage the capital position</b>	<b>8</b>
<b>Stress testing</b>	<b>9</b>
<b>Review of the ICAAP</b>	<b>10</b>
<b>ICAAP summary statement</b>	<b>11</b>
<b>ICAAP report</b>	<b>11</b>
<b>Part B – APRA supervisory review</b>	<b>13</b>
<b>A three-pillar approach to capital adequacy</b>	<b>13</b>
<b>Principles underlying the Pillar 2 supervisory review process</b>	<b>13</b>
<b>Supervisory adjustments</b>	<b>14</b>
Types of supervisory adjustment	14
Circumstances in which a Pillar 2 supervisory adjustment may be considered	15
Processes for determining Pillar 1 and Pillar 2 supervisory adjustments	16

# Part A – Internal Capital Adequacy Assessment Process

## Board ownership of the ICAAP

1. Under the capital standards, the Board of a regulated institution has primary responsibility for the capital management of that institution. This obligation goes beyond the need to ensure compliance with regulatory capital requirements and requires the Board to ensure that each regulated institution holds capital resources commensurate with its risk profile.
2. Consistent with that overarching responsibility, the capital standards require each regulated institution to have an ICAAP that has been approved by its Board.
3. While the ICAAP may be developed by the regulated institution's senior management with input from relevant areas and experts across the organisation (including the Appointed Actuary where relevant), the capital standards require the Board to be actively engaged in the development and finalisation of the ICAAP and the oversight of its implementation on an ongoing basis.
4. APRA expects the Board to robustly challenge the assumptions and methodologies behind the ICAAP and the associated documentation. APRA expects the Board to understand and to be able to explain the key aspects of the ICAAP and why it is considered appropriate for the institution.
5. APRA expects the ICAAP to be integrated into the decision-making processes of the regulated institution and considered in strategic and business planning.
7. An ICAAP involves an integrated approach to risk management and capital management, based around assessing the level of, and appetite for, risk in the regulated institution and ensuring that the level and quality of capital is appropriate to that risk profile. APRA expects these processes of risk and capital considerations to have clear linkages, and be consistent with one another and with the business planning process. The processes will also be embedded in the institution's operations and be key inputs into decision-making.
8. APRA expects that the risk appetite and risk management framework of a regulated institution will address all material sources of risk for that institution. This will include risks that are covered by specific regulatory capital requirements and risks that are not, regardless of whether those risks are able to be quantified.
9. Since a regulated institution is required under the capital standards to have an appropriate ICAAP in place at all times, it follows that material changes in its risk profile or risk appetite would prompt a reconsideration of capital needs and a review of the ICAAP.

## Requirements for the ICAAP

10. The capital standards set a number of minimum requirements for an ICAAP, which include:
  - (a) processes for assessing the risks arising from a regulated institution's activities and ensuring that capital held is commensurate with the level of risk; and
  - (b) a strategy for maintaining adequate capital over time, including the setting of capital targets consistent with the risk profile of the institution, the risk appetite and regulatory capital requirements.<sup>1</sup>

## Risk appetite and risk management framework

6. The Board is responsible for the risk appetite of a regulated institution and for ensuring that the institution has an appropriate risk management framework. Risk appetite is a fundamental part of both risk management and capital management.

<sup>1</sup> For ADIs, this will include the capital conservation buffer and any countercyclical capital buffer.

## **Risk coverage**

11. APRA expects that the ICAAP will consider all risks to which the regulated institution is exposed, both individually and in aggregate. As an indication:
  - (a) for insurers, this will include asset risk, credit risk, asset/liability mismatch risk, insurance risk, asset concentration risk, insurance concentration risk and liquidity risk;
  - (b) for ADIs, this will include credit risk, liquidity risk, market risk, interest rate risk in the banking book and risks associated with securitisation;
  - (c) for all regulated institutions, this will include operational risk, strategic and reputational risks and contagion risks. Other risks may be relevant for individual regulated institutions and, if so, will ordinarily be considered in the ICAAP; and
  - (d) for Level 3 groups, this will include potential contagion risks relating to the group's non-APRA-regulated activities. It will also include risks relating to the group's insurers and ADIs, as set out above, and its RSE licensees.
12. Correlations between and within risk categories are a potential source of capital volatility. Historical experience shows that these correlations can change rapidly, particularly in times of stress in markets. The ICAAP of a regulated institution will ordinarily have regard to the potential impact of volatility in any assumed correlations.

## **Proportionality**

13. Under the capital standards, the ICAAP of a regulated institution must be appropriate for its size, business mix and complexity. Each institution's ICAAP will be tailored to the circumstances of the institution. For more complex institutions, appropriately sophisticated processes are expected; for simpler institutions with limited product offerings and simple investment structures, simplified approaches may suffice. The complexity or otherwise of an

institution's ICAAP will be expected to reflect the Board's and senior management's view of the institution's functional complexity.

## **Forward-looking capital management**

14. Prudent practice is for regulated institutions to ensure that capital management is forward-looking, having regard to changes in strategy, business plans, operating environment and other factors that might impact on the risk profile of the institution and the capital resources available. In addition to changes in business plans and operating environment that have been anticipated by the regulated institution, the institution will also typically consider how it could react to unanticipated changes. External factors such as a period of strong credit growth in the economy can be relevant considerations to take into account (particularly for ADIs given their potential impact on regulatory capital requirements if a countercyclical capital buffer is invoked).

## **Group ICAAP considerations**

15. Where relevant, a regulated institution's ICAAP will also typically take into account the risks to which that institution is exposed due to its membership of a broader corporate group (whether or not that group is an APRA-regulated Level 2 or Level 3 group). These risks can include contagion risks, counterparty risks, reputational risks and risks related to operational dependencies such as shared functions and systems. Assessment of capital resources at a group level will need to have regard to the transferability of capital between group entities in a range of market conditions. At Level 3, 3PS 110 requires the group ICAAP to include a process for assessing and addressing the capital shortfall assessment.
16. Under the capital standards, a regulated institution may make use of a group ICAAP or components of that ICAAP. In doing so, the Board of each regulated institution in the group is still required to ensure that the ICAAP is appropriate and meets the requirements of the capital standards in relation to the institution.

17. APRA expects a Level 3 group ICAAP to take into account the Level 1 and Level 2 ICAAPs of regulated institutions in the group. This includes consideration of interactions between Level 1 and Level 2 ICAAPs of group members.

### Documenting the ICAAP

18. A regulated institution's ICAAP will include a range of processes and systems for assessing capital requirements relative to the risks to which the institution is exposed, setting target capital levels, projecting and monitoring the capital position, taking action if capital levels fall below target levels, and reporting on the process and its outcomes to the Board. These underlying processes will ordinarily be documented in various policies and procedural documents.
19. The capital standards require a regulated institution to document its internal processes for assessing capital adequacy in an ICAAP summary statement and an ICAAP report (discussed below). Under the capital standards, the processes documented in the ICAAP must be those that are actually used by the regulated institution.

### Setting the target levels of capital

20. A key component of an ICAAP is the setting of target levels of capital. The capital standards require a regulated institution, as part of the ICAAP, to set capital targets based on its own assessments of its capital needs. Capital targets will have regard to, but not be set solely by reference to, regulatory capital requirements. Both the quantity and quality of capital will ordinarily be assessed by the institution. An institution will typically consider both bottom-up (for example, by summing capital amounts for individual risks) and top-down (for example, by stress testing of the overall capital position) perspectives on the adequacy and composition of its capital.
21. APRA expects that the Board will satisfy itself that the capital targets are in line with the risk appetite. This will include consideration of the Board's appetite for potential breaches of regulatory capital requirements.

22. A range of considerations will ordinarily be taken into account in setting capital targets:
  - (a) the risk appetite of the regulated institution;
  - (b) regulatory capital requirements;
  - (c) internal assessments of capital needs, including those arising from the institution's business plans and strategy;
  - (d) the likely volatility of profit and the capital surplus;
  - (e) dividend policy;
  - (f) where relevant, ratings agency assessments; and
  - (g) access to additional capital.
23. There is a range of approaches that institutions can use in setting target capital levels including stress testing approaches. While APRA does not require an economic capital model to be used, a more sophisticated institution may choose to use such a model as well as stress testing.
24. A key purpose of setting capital targets that exceed regulatory minima is to protect against breaches of the Prudential Capital Requirement (PCR), enabling a regulated institution to continue operating in the event of significant stress. Under the capital standards, a regulated institution will be subject to minimum requirements in relation to Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital.<sup>2</sup> Such requirements may be set by the operation of the prudential standards or specifically modified by APRA applying a Pillar 2 adjustment. Accordingly, a regulated institution will typically consider the possibility of breaching the capital requirements in respect of each of these components and set targets accordingly. This will necessarily include consideration of an appropriate composition of the capital buffers, taking account of the need for the buffers to perform their function of absorbing losses on an ongoing basis to allow the institution to continue to operate in the face of stressed conditions.

<sup>2</sup> In the case of Level 3 groups, the minimum requirement will be in relation to Level 3 EC.

## Strategy for maintaining adequate capital over time

25. A regulated institution's strategy for ensuring that adequate capital is maintained over time, as required under the capital standards, will typically take account of a range of capital-generating and capital-consuming factors:
- (a) the extent of organic capital growth through retained earnings;
  - (b) the ability to access additional external capital of any form: whether Common Equity Tier 1 Capital<sup>3</sup>, Additional Tier 1 Capital or Tier 2 Capital, including, where relevant, the ability and willingness of the major shareholders, parent company or broader group to contribute additional capital to the regulated institution;
  - (c) the extent of additional capital necessary to cover planned business growth, whether organic or by acquisition;
  - (d) the extent to which the institution can take action to lower its required capital (e.g. by reducing risk-weighted assets for ADIs or de-risking to reduce the prescribed capital amount for insurers);
  - (e) the need to ensure adequate immediate and projected capital coverage in a wide range of market and economic conditions, including severely stressed scenarios, over a reasonable period of time (taking into account, where relevant, any ability of the capital conservation or countercyclical capital buffers to absorb losses incurred during severe levels of stress);
  - (f) economic capital requirements; and
  - (g) where relevant, the impact of ratings agency assessments, shareholder expectations and market considerations on capital needs.

## Trigger levels and related actions to manage the capital position

26. To avert capital falling below target operating levels and, in the most severe case, breaching regulatory requirements, an institution is required under the capital standards to have capital triggers in place. These triggers are intended to serve as early warning indicators and thereby provide the Board and senior management with time to rectify problems and restore capital while the institution continues to operate.
27. APRA expects that there will be a graduated series of triggers above the PCR to protect against breaches of the PCR and to manage capital on an ongoing basis. The sets of potential actions associated with the various triggers will vary according to the nature of the stress and, ordinarily, will increase in intensity as capital surplus reduces. APRA expects very strong immediate actions in the event of a breach of the PCR.
28. APRA acknowledges that the capital position of a regulated institution will vary around target capital levels set in the ICAAP over time, and may fall below target capital levels from time to time. This is acceptable as long as the regulated institution acts in accordance with the trigger points and actions set out in its ICAAP, including reporting to APRA as appropriate (and subject always to the requirement that the institution not breach the PCR).
29. A range of actions may be available to a regulated institution to protect its capital position, including:
- (a) raising additional external capital or capital from group sources;
  - (b) adjustments to dividend policy and dividend reinvestments plans;
  - (c) slowing or ceasing new business;
  - (d) in the case of insurers, entering into reinsurance arrangements;
  - (e) sales of parts of the business;
  - (f) asset sales;

<sup>3</sup> In the case of Level 3 groups, Level 3 EC.



- (g) changes to investment strategy;
- (h) changes to product pricing; and/or
- (i) changes to business mix.

30. In considering these actions, a regulated institution will typically have regard to:
  - (a) the extent to which the action would improve the capital position;
  - (b) the timeframe over which the action would have effect;
  - (c) whether the action is realisable in a severely stressed scenario;
  - (d) whether there are dependencies (such as on key investors or particular markets) and relevant contingency plans; and
  - (e) the impact of the actions on the franchise value of the business and its ability to operate as a going-concern.
31. In addition to the actions available to a regulated institution to manage its capital position, APRA has the ability to trigger a non-viability event in relation to a regulated institution under *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111), *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* or *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*. APRA expects that regulated institutions will consider actions to protect its capital position that will obviate the need for APRA to declare a non-viability trigger event.
32. APRA expects that a regulated institution will have in place procedures for reacting to receipt of a notice of a non-viability trigger event from APRA, including processes to ensure that conversion or write-off occurs in line with the requirements of the relevant prudential standard.
33. For ADIs, APS 111 requires that Additional Tier 1 instruments classified as liabilities must be converted or written-off where the ADI's Common Equity Tier 1 Capital ratio falls to or below 5.125 per cent of risk-weighted assets. APRA expects an ADI's ICAAP to include early warning signals as well as measures to ensure

conversion or write-off happens immediately and irrevocably. This will include processes to monitor whether the trigger has been reached and processes to execute the necessary conversion or write-off in line with the requirements of APS 111.

## Stress testing

34. The capital standards require a regulated institution to include stress testing and scenario analysis in its ICAAP. Stress testing and scenario analysis can assist in the formulation of capital targets and trigger levels by:
  - (a) assisting the regulated institution to understand its risk profile;
  - (b) indicating and validating key assumptions (such as those assumptions to which the outcome is most sensitive);
  - (c) testing the appropriateness of proposed capital targets;
  - (d) testing the risk appetite of the institution against its ability to bear risk (i.e. the risk capacity);
  - (e) providing a reasonableness check on the outputs of capital modelling (whether an APRA-approved internal model used for calculating regulatory capital requirements or other models used in capital management and planning); and
  - (f) being readily understandable to the Board and senior management.
35. Stress testing and scenario analysis will be tailored to the individual regulated institution and its particular risk exposures. Scenarios will typically cover the full range of material risks to which the institution is exposed.
36. A range of approaches may be useful:
  - (a) scenario analysis including:
    - (i) historical scenarios (such as the global financial crisis experience, early 1990's Australian recession, 1987 stock market event, Japan's 1990's 'lost decade');

- (ii) statistically generated scenarios; and
    - (iii) hypothetical scenarios developed by the institution;
  - (b) sensitivity testing;
  - (c) stress testing based on statistical factors or historical experience;
  - (d) reverse stress testing designed to identify a stress scenario that would cause failure of the regulated institution;
  - (e) longer-term scenarios (such as the impact of a prolonged low interest rate or low investment earnings environment) and short-term scenarios (such as market shocks and insurance events); and
  - (f) a combination of scenarios (e.g. a series of less severe but more frequent events).
37. A regulated institution will typically make use of a range of stress scenarios in its testing program. APRA expects that stress scenarios considered will range in impact and include very severe scenarios.
38. In the case of a Level 3 group, APRA expects the Level 3 ICAAP to appropriately consider the interactions of industry-specific stresses. This includes an assessment of the potential for any cross-industry diversification benefits assumed, in establishing the target surplus, to be significantly reduced or for contagion risk to increase in times of stress.

## Review of the ICAAP

39. The capital standards require a regulated institution to arrange for regular and robust review of its ICAAP by appropriately qualified persons who are operationally independent of the conduct of capital management. A range of reviewers may be utilised as part of the independent review process to take advantage of diverse skills and functions. For example, a regulated institution may make use of internal audit, external audit, risk management personnel or other external consultants to undertake aspects of the review. Importantly, APRA has not required that the review be undertaken by an external party. Internal resources may be appropriate, where it can be demonstrated that they have the requisite skills and operational independence.
40. The required review does not have to cover the entire ICAAP in one review. It may be appropriate for a regulated institution to implement a review program designed to cover the whole ICAAP process over time, by way of a series of focussed reviews of individual components of the overall process. Regardless of the structure of the review program, APRA expects that it will comprehensively cover the ICAAP over a reasonable timeframe (such as three years).
41. It will be appropriate to consider a range of factors in reviewing the ICAAP, including:
- (a) the ongoing appropriateness of the assumptions and methodologies used in the ICAAP;
  - (b) the appropriateness of the stress and scenario testing;
  - (c) any limitations of the ICAAP;
  - (d) the accuracy and extent of data relied on in calculations;
  - (e) the consistency of the ICAAP outcomes with the risk appetite of the Board and the risk capacity of the entity;
  - (f) the effectiveness of key controls relied upon for the purposes of the ICAAP;
  - (g) any non-compliance with the policies and procedures underpinning the ICAAP and the actions taken to address such non-compliance;
  - (h) the appropriateness of planned capital outcomes;
  - (i) the appropriateness of planned changes to the ICAAP;
  - (j) changes in the external environment;
  - (k) changes to the risk appetite and risk profile of the institution;
  - (l) the group ICAAP, if relevant; and
  - (m) developments in industry good practice.

42. APRA expects that a regulated institution will have in place processes to report the outcomes of the review to the Board and senior management, as well as processes to assess and respond to any recommendations for change arising out of the review.

### ICAAP summary statement

43. An ICAAP summary statement is a high-level document that describes and summarises the capital assessment and management processes of the regulated institution. It serves as a roadmap to the ICAAP that allows the Board and APRA to understand the capital management processes of the institution. APRA anticipates that the ICAAP summary statement will refer to other policies and procedures, but will be relatively self-contained.
44. APRA has not mandated any particular format for the ICAAP summary statement – a regulated institution is able to adopt the form that best suits the circumstances of its business. APRA also has not mandated that the ICAAP summary statement and ICAAP report (discussed below) be contained in separate documents. If a regulated institution chooses to do so, it may address the two requirements in a single document, subject to meeting all the requirements of the capital standards. Note, however, that the ICAAP report is required to be updated each year, whereas the summary statement may have a longer life.
45. In addition to the items required in the capital standards, the ICAAP summary statement will typically also include:
- (a) a description of the risk appetite of the institution, including a statement of the actual appetite for risk, how it has been derived and how it is integrated with strategic and business planning, risk management and capital management;
  - (b) a clear statement of the scope and coverage of the ICAAP, including its application to group entities where relevant;
  - (c) a description of the key internal controls relied upon for the ICAAP;
  - (d) a description of the approaches to, and processes for, risk assessments and capital allocation, and the linkages between these processes;
  - (e) a description of the procedures and persons involved in approving, reviewing and monitoring compliance with the ICAAP;
  - (f) an outline of the procedures and persons responsible for the ongoing implementation of the ICAAP;
  - (g) a description of the approach to capital allocation including the basis on which it has been undertaken; and
  - (h) if allowances have been made for diversification, how these allowances have been derived.

### ICAAP report

46. As for the ICAAP summary statement, APRA has not mandated any particular format for the ICAAP report. Neither the ICAAP summary statement nor ICAAP report need to be prepared specifically for APRA; documents used for internal purposes can be used to meet the APRA requirements, so long as the requirements of the capital standards are satisfied.
47. The ICAAP summary statement and ICAAP report are prepared for distinct purposes and are conceptually separate. The ICAAP summary statement is a point-in-time summary description of the capital management processes of the regulated institution. The annual ICAAP report details the outcomes of the implementation of these processes over the previous year and also looks forward for at least a three-year period to illustrate expected capital outcomes. APRA's expectation is that the ICAAP report is likely to change significantly from year-to-year, while the ICAAP summary statement will be relatively stable over time.

48. For insurers, it may be appropriate in some circumstances to incorporate the ICAAP report into the Financial Condition Report (FCR) prepared by the Appointed Actuary. Such an approach can aid in administrative simplicity but APRA does not expect an insurer to take this approach unless the Board of the insurer is satisfied that, in so doing, the independence of the Appointed Actuary is not compromised and that the Board retains clear ownership of the ICAAP. In order to demonstrate that ownership, it is appropriate for the ICAAP report to form a separately identifiable and distinct sub-component of the FCR. It is not appropriate for the Board to simply accept without challenge the work of the Appointed Actuary in producing the ICAAP report. APRA expects in most cases that the ICAAP report will be a separate document.
49. The timing of the ICAAP report is a matter for the individual regulated institution, subject to the overall requirement that the report be completed annually. An institution may choose to prepare the report as part of its annual planning process, or may choose to undertake it as part of the year-end reporting process. Where an insurer elects to include the ICAAP report in the FCR, the combined report will need to be provided to APRA within the allowed timeframe for submission of the FCR under *Prudential Standard LPS 320 Actuarial and Related Matters* or *Prudential Standard GPS 320 Actuarial and Related Matters*.
50. APRA anticipates that the ICAAP report will involve both quantitative and qualitative analysis. Sufficient detailed description will typically be provided to explain how quantitative results have been derived.
51. In addition to the items required in the capital standards, the content of an ICAAP report will typically include:
  - (a) details of planned capital management actions and other management actions impacting on the capital position with explanations of why they are being undertaken and their impact. This includes dividends, buy-backs, capital transfers, issue of capital instruments, redemptions of instruments and major asset or liability transactions that impact on the capital position;
  - (b) a description of action plans (including timeframes) if the capital projections contained in the report show a need to raise capital or take other actions to protect the capital position;
  - (c) a description of the regulated institution's current regulatory capital, including key contractual terms of its capital instruments. A description of the key areas of difference between any Additional Tier 1 Capital or Tier 2 Capital instruments and Common Equity Tier 1 Capital is likely to be useful;
  - (d) an assessment of the expected sources and uses of capital over the planning horizon assuming both expected and stressed conditions;
  - (e) an assessment of anticipated changes in the regulated institution's risk profile over the planning horizon. This will include any expected changes outlined in the institution's business plan or strategy that would be likely to have a material impact on its capital position. It will also, at Level 2 and Level 3, have regard to any proposed changes in group composition and structure over the planning horizon; and
  - (f) where relevant, reconciliation of economic and regulatory capital including explanation of the areas of difference and their impact on the result.

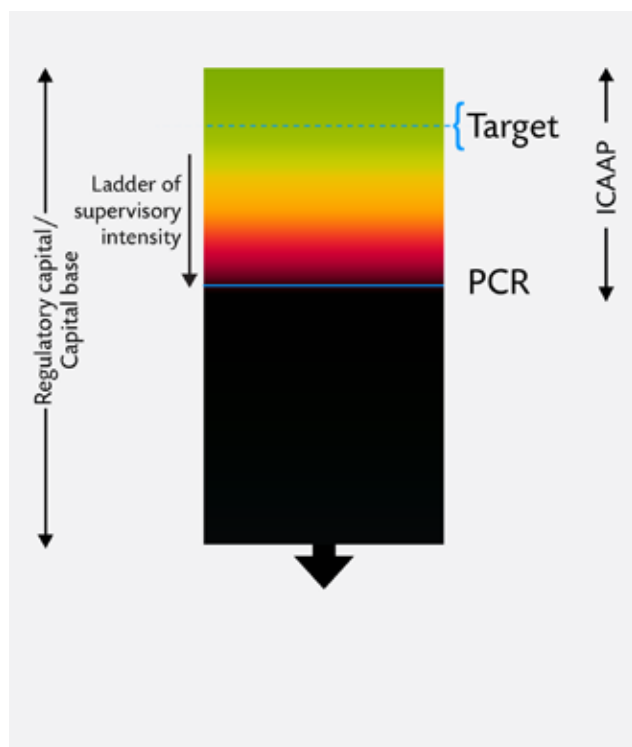
## Part B – APRA supervisory review

### A three-pillar approach to capital adequacy

52. APRA's capital adequacy framework for a regulated institution is based on a three pillar approach. The three pillars, intended to be mutually reinforcing, are as follows:
- (a) Pillar 1 – quantitative requirements in relation to required capital, eligible capital and liability valuations;
  - (b) Pillar 2 – the supervisory review process, which includes supervision of the risk management and capital management practices of regulated entities and may include a supervisory adjustment to capital; and
  - (c) Pillar 3 – disclosure requirements designed to encourage market discipline.
53. From a purely capital perspective:
- (a) the Pillar 1 required capital of a regulated institution is determined in accordance with the applicable prudential standards;
  - (b) as part of the Pillar 2 supervisory process, APRA may require a regulated institution to meet a PCR above the minimum amount calculated in accordance with the prudential standards, known as a 'supervisory adjustment', 'Pillar 2 supervisory adjustment' or 'Level 3 supervisory adjustment'; and
  - (c) Pillar 3 disclosure allows market participants to better assess the capital adequacy of an institution with respect to its risks. This is especially important given the information asymmetries that exist between regulated institutions and market participants. The Basel Committee on Banking Supervision has highlighted poor market disclosure as a factor that has hindered the ability of market participants to properly assess the capital adequacy of banks.

### Principles underlying the Pillar 2 supervisory review process

54. Four key principles underpin APRA's Pillar 2 supervisory review of capital adequacy:
- (a) each regulated institution must have an ICAAP, approved by its Board. APRA's expectations regarding ICAAPs are set out in the capital standards and in this PPG;
  - (b) APRA will review and evaluate a regulated institution's ICAAP and take supervisory action if it is not satisfied with the quality of the ICAAP;
  - (c) each regulated institution must operate above its PCR and in accordance with the framework of target capital levels and trigger points it has established in its ICAAP. APRA will adjust the PCR where there are prudential reasons to do so. These supervisory adjustments are made under the capital standards and are discussed below; and
  - (d) APRA will intervene at an early stage if a regulated institution's capital shows any signs of falling below the PCR and will require remedial action if capital is not maintained or restored.
55. The intensity of APRA's supervisory attention will increase as the regulated institution's capital level approaches the PCR. The PCR is the regulatory minimum and any breach of the PCR can be expected to generate immediate supervisory action. A regulated institution that breaches the PCR will therefore need to take immediate steps to address this breach if it is to avoid explicit intervention by APRA.



56. Capital adequacy also depends heavily on the way a regulated institution monitors and manages its capital position and its risks. APRA therefore considers its supervision of a regulated institution's capital management and risk management to be of utmost importance.

## Supervisory adjustments

### Types of supervisory adjustment

#### For ADIs

57. APS 110 sets absolute minimum PCRs for Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital. APRA has the ability, however, to apply a supervisory adjustment (Pillar 2 supervisory adjustment) such that an ADI is required to meet a PCR greater than these absolute minimum levels. In these cases, the ADI's PCR will be the amounts determined by APRA in respect of Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital.
58. The capital conservation buffer (not shown on the diagram) is in addition to the minimum Common Equity Tier 1 requirement, and capital distribution constraints are automatically imposed on an ADI when its capital levels fall within the buffer range. APRA will add the capital conservation buffer to the Common Equity Tier 1 PCR that it determines for an ADI, which may be at or above the minimum in APS 110. APRA will, however, have regard to the cumulative impact of its capital requirements when determining the size of the capital conservation buffer to apply to an ADI.
59. APS 110 also introduces a countercyclical buffer designed to ensure that banking system capital requirements take account of the macro-financial environment in which ADIs operate. This buffer will be imposed, through an extension of the capital conservation buffer, when aggregate credit growth is judged by APRA to be associated with a build-up of system-wide risk.

#### For general insurers and life insurers

60. For insurers, a supervisory adjustment to minimum capital may take the form of an addition to the prescribed capital amount. In these cases, the insurer's PCR will be the prescribed capital amount calculated under the prudential standards plus any supervisory adjustment to the prescribed capital amount. Alternatively, APRA may apply an adjustment to the minimum requirements for the composition of the capital base used to meet the PCR. As an indication, APRA may make such an adjustment where it has concerns about the relative levels of the different components of capital held by the insurer, or where APRA is concerned about the quality of the surplus capital and its loss-absorbing ability. These types of supervisory adjustments are referred to as 'Pillar 2 supervisory adjustments'.

61. For insurers, APRA also has the power to adjust any aspect of the prescribed capital amount calculation where, in its view, application of the method outlined in the prudential standard does not produce an appropriate outcome. This type of supervisory adjustment is referred to as a 'Pillar 1 supervisory adjustment'. Such an adjustment could result in an increase or decrease in the prescribed capital amount depending on the circumstances and nature of the adjustment. This power will be used where interpretation of the requirements in the standard by an insurer is seen by APRA as being incorrect or inappropriate, or where unusual asset structures or lines of business that are intended to be covered by one of the capital charges are not specifically captured in the standard. For example, an adjustment could be made for unusual types of derivative transactions that are not fully captured under the Asset Risk Charge or newly developed products which are not contemplated under the Standard Method set out in the prudential standards. An adjustment could be made, for example, by specifying a different parameter in the calculation process to that prescribed in the prudential standard.

#### For Level 3 groups

62. For Level 3 groups, a Level 3 supervisory adjustment to minimum capital may take the form of an addition to the Level 3 prescribed capital amount. In these cases, the group's Level 3 PCR will be the Level 3 prescribed capital amount, calculated under 3PS 110, plus any Level 3 supervisory adjustment.
63. APRA also has the power to adjust or exclude a specific requirement in relation to a Level 3 Head. This includes the ability to adjust any aspect of the Level 3 prescribed capital amount calculation where, in APRA's view, application of the method outlined in the prudential standard does not produce an appropriate outcome. Such an adjustment could result in an increase or decrease in the Level 3 prescribed capital amount depending on the circumstances and nature of the adjustment.

#### Circumstances in which a Pillar 2 supervisory adjustment may be considered

64. As a non-exhaustive indication, APRA may consider imposing a supervisory adjustment on a regulated institution in a range of circumstances, including:
- (a) the calculation of required capital set out in the prudential standards does not adequately address the risks specific to the institution (e.g. strategic risk, reputation risk or other risks not adequately catered for by those capital calculations due to some aspect of the institution's business or operations)<sup>4</sup>;
  - (b) the institution is using a business model, has an organisational structure or is following a business strategy that APRA regards as highly risky, or overly difficult to assess, in a way that is not captured under the calculation of required capital set out in the prudential standards;
  - (c) the institution is newly licensed or has recently materially changed, or plans to materially change, its business mix;
  - (d) APRA has identified material issues with the competence or probity of responsible persons associated with the institution;
  - (e) APRA has identified material weaknesses in the institution's governance, or deficiencies in the suitability, adequacy or effectiveness of its risk management framework or strategy;
  - (f) the institution has failed to comply with applicable prudential standards, or has complied in a way that, in APRA's view, is not consistent with the spirit or intent of those standards;
  - (g) the institution's ICAAP is not well-defined or documented, or its target capital policy is assessed as being inadequate, e.g. due to a lack of sufficiently rigorous stress and scenario testing;
  - (h) APRA has concerns about the relative levels of the different components of capital held by the institution or about the quality of the surplus capital and its loss-absorbing ability;

<sup>4</sup> In the case of Level 3 groups, this includes situations where APRA considers that the group's internal capital allocation does not adequately reflect all material risks to APRA beneficiaries.

- (i) the institution has been unable to restore its capital position to target capital levels in accordance with its ICAAP in a timely manner;
  - (j) the institution is exposed to significant reputational or contagion risks from the group to which it belongs (whether or not that group is an APRA-regulated Level 2 or Level 3 group); or
  - (k) in the case of a Level 3 group:
    - (i) APRA has concerns about the location of capital across the group, including its transferability; or
    - (ii) the group is exposed to an imprudent level of aggregate risk exposures or intra-group transactions and exposures.
  - (d) review of the ICAAP;
  - (e) discussions with the regulated institution;
  - (f) any plans by the regulated institution to address APRA's concerns, including the clarity, viability and timeliness of the plans; and
  - (g) any other information held or sought by APRA.
67. The reasons leading to the decision to apply a supervisory adjustment will be disclosed to the regulated institution. Depending on the basis for the proposed adjustment, APRA may first seek to have the regulated institution address the areas of concern through, for example, changes to its operations, governance or risk and capital management framework or processes. If a supervisory adjustment has been imposed and the regulated institution has subsequently addressed the issues that led to the adjustment, APRA will review the need for continuation of the supervisory adjustment.

### **Processes for determining Pillar 1 and Pillar 2 supervisory adjustments**

65. Any supervisory adjustment will typically be determined as part of APRA's regular supervisory assessment of a regulated institution, and institutions are already familiar with APRA's overall supervisory approach. As with other supervisory decisions, consideration by APRA of the need for, and nature of, any supervisory adjustment to prescribed capital will typically involve discussions with the regulated institution. APRA reserves the right, however, to impose a supervisory adjustment outside of the ordinary supervisory process if it is considered necessary to do so. This may occur, for example, where APRA determines it is necessary to act rapidly to protect the interests of policyholders or depositors.
66. A decision whether to impose a supervisory adjustment, and the size of that adjustment, will be based on information available to APRA from the full range of APRA's supervision activities, including:
- (a) off-site analysis;
  - (b) on-site reviews;
  - (c) PAIRS assessment/SOARS stance<sup>5</sup>;
68. The process for determining any supervisory adjustment, including implementation timing, will be subject to APRA's internal governance processes, including review at appropriate levels within APRA. APRA's processes for determining supervisory adjustments include comparisons of a regulated institution within relevant peer groups.

<sup>5</sup> PAIRS is APRA's Probability and Impact Rating System, SOARS is APRA's Supervisory Oversight and Response System. (For further information refer to <http://www.apra.gov.au/AboutApra/Pages/Supervision.aspx>.)





Telephone  
1300 55 88 49

Email  
[info@apra.gov.au](mailto:info@apra.gov.au)

Website  
[www.apra.gov.au](http://www.apra.gov.au)

Mail  
GPO Box 9836  
in all capital cities  
(except Hobart and Darwin)