



Prudential Standard 3PS 111

Capital Adequacy: Measurement of Capital

Objective and key requirements of this Prudential Standard

This Prudential Standard sets out the characteristics that an instrument must have to qualify for inclusion in the eligible capital of a Level 3 group and the various regulatory adjustments to be made to determine eligible capital on a Level 3 basis.

The ultimate responsibility for ensuring that a Level 3 group's eligible capital meets the requirements of this Prudential Standard rests with the Board of its Level 3 Head.

The key requirements of this Prudential Standard are that the Level 3 Head must ensure that the Level 3 group:

- includes in its eligible capital only those capital instruments that meet the detailed criteria set out in this Prudential Standard;
- ensures all capital instruments are capable of bearing loss; and
- makes certain regulatory adjustments to capital to determine its eligible capital.

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Authority

1. This Prudential Standard is made under:
 - (a) section 11AF of the *Banking Act 1959* (Banking Act);
 - (b) section 32 of the *Insurance Act 1973* (Insurance Act); and
 - (c) section 230A of the *Life Insurance Act 1995* (Life Insurance Act).

Application

2. This Prudential Standard applies to each **Level 3 Head**. A Level 3 Head must ensure that the requirements in this Prudential Standard are met by the **Level 3 group**, where applicable.
3. This Prudential Standard commences on 1 January 2014.

Interpretation

4. Terms that are defined in *Prudential Standard 3PS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.

Interaction with other prudential standards

5. The requirements in this Prudential Standard are in addition to the obligations imposed on **APRA-regulated institutions** by other Prudential Standards.

Components of capital

6. For the purposes of this Prudential Standard, a ‘component of capital’ is any form of capital defined in this Prudential Standard as eligible for inclusion in Level 3 eligible capital (Level 3 EC).¹
7. A Level 3 group must ensure that any component of capital included in its Level 3 EC satisfies, in both form and substance, all requirements in this Prudential Standard.
8. A Level 3 group must not include a component of capital in Level 3 EC if that component, when considered in conjunction with other related transactions that affect its overall economic substance, could be reasonably considered not to satisfy the requirements of this Prudential Standard for Level 3 EC.
9. A Level 3 group must not include a component of capital in Level 3 EC based on a future event until such time as:
 - (a) the future event occurs; and
 - (b) the proceeds have been irrevocably received by the group.

¹ Level 3 EC is defined in paragraph 13.

10. APRA may, in writing, require a Level 3 Head to exclude from the Level 3 group's Level 3 EC any component of capital that in APRA's opinion is not a genuine contribution to the financial strength of the group.

Application of fair values

11. A Level 3 group may measure its financial instruments at fair value for capital adequacy purposes provided it complies with **Australian Accounting Standards**.

Level 3 eligible capital

12. Level 3 EC comprises the highest quality components of capital that fully satisfy all of the following characteristics:
 - (a) provide a permanent and unrestricted commitment of funds;
 - (b) are freely available to absorb losses;
 - (c) do not impose any unavoidable servicing charge against earnings; and
 - (d) rank behind the claims of depositors, **policyholders** and other creditors in the event of winding-up of the issuer.
13. 'Level 3 EC' consists of the sum of:
 - (a) paid-up ordinary shares issued by the Level 3 Head that meet the criteria in Attachment A to this Prudential Standard;
 - (b) retained earnings;
 - (c) undistributed current year earnings (refer to paragraphs 15 to 18 inclusive);
 - (d) accumulated other comprehensive income and other disclosed reserves (refer to paragraphs 19 to 21 inclusive);
 - (e) minority interests determined in accordance with:
 - (i) *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111), paragraph 19(e) where the reference to **third parties** must be taken to mean third parties of a Level 3 group, rather than of an **ADI Level 2 group**; and
 - (ii) *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112), Attachment I, paragraph 3, where the reference to third parties must be taken to mean third parties of a Level 3 group, rather than of a **general insurance Level 2 group**;
 - (f) for a general insurance Level 2 group, or, where none is present, the **general insurers** (GIs) and equivalent overseas general insurers on a

standalone basis, technical provisions² in surplus or deficit of those required by *Prudential Standard GPS 320 Actuarial and Related Matters* (GPS 320)^{3,4}; and

- (g) regulatory adjustments applied in the calculation of Level 3 EC in accordance with Attachment B to this Prudential Standard.
14. Unless otherwise noted, a Level 3 group must apply a consolidated Level 3 group basis to determine the items listed in paragraph 13.
 15. Current year earnings must take into account:
 - (a) negative goodwill;
 - (b) the unwinding of any discount on credit loss provisions for authorised deposit-taking institutions (**ADIs**)⁵ in a Level 3 group (refer to Attachment A of *Prudential Standard APS 220 Credit Quality*);
 - (c) expected tax expenses; and
 - (d) dividends when declared in accordance with Australian Accounting Standards.
 16. Declared dividends for the purpose of paragraph 15(d) may be reduced by the expected proceeds, as agreed in writing by APRA, of a Dividend Reinvestment Plan (DRP) to the extent that dividends are used to purchase new ordinary shares issued by the Level 3 Head. A Level 3 Head must review every six months the expected subscription for new ordinary shares under its DRP, having regard to experience over previous years and reasonable expectations of the level of subscription that might apply in future. If a Level 3 Head identifies any material change in the expected level of future subscription for new ordinary shares under its DRP, it must notify APRA and obtain APRA's agreement to a new amount by which declared dividends may be reduced for Level 3 EC purposes.
 17. For ADIs⁶ in a Level 3 group, current year earnings also include the full value of upfront fee income provided that:
 - (a) the fee income has either been received in cash or has been debited to a customer's account or otherwise forms part of the upfront fees owed by a customer;

² Technical provisions in this instance refer to both outstanding claims provisions and unearned premium calculated under Australian Accounting Standards. Technical provisions in surplus or deficit relating to premium liabilities also include the deferred reinsurance expense for future business not yet written.

³ Technical provisions in surplus or deficit of those required by GPS 320 must be adjusted to take account of tax effects.

⁴ Equivalent overseas general insurers included in the GI block on a standalone basis must apply the approach set out for 'international business' in GPS 320.

⁵ Or the **ELE** where applicable.

⁶ Or the ELE where applicable.

- (b) outstanding amounts of fee income debited to customer accounts must be claimable in full in the event of default by the customer, or capable of being sold to a third party as part of outstanding debts;
 - (c) the provider of the income has no recourse for repayment in part or full of any prepaid income;
 - (d) the customer cannot cancel any fees debited to the customer's account for which they were otherwise obliged to pay upfront; and
 - (e) there is no requirement for the provision of continuing additional services or products associated with the fee income concerned.
18. Fee income may include net positive amounts arising from the netting of deferred income and capitalised expenses associated with a product class provided the conditions in paragraph 17 are satisfied.
19. Accumulated other comprehensive income and other disclosed reserves include, but are not limited to:
- (a) unrealised gains or losses recognised on the balance sheet;
 - (b) reserves from equity-settled share-based payments (share or share options) granted to employees as part of their remuneration package provided that:
 - (i) the share or share options granted relate only to the ordinary shares of the Level 3 Head;
 - (ii) the ordinary shares comprise only new ordinary shares to be issued by the Level 3 Head, or new ordinary shares already issued by the Level 3 Head for this specific purpose; and
 - (iii) there are no circumstances under which such remuneration can be converted into another form (e.g. cash).
- Any other reserves associated with share-based payments must be excluded from Level 3 EC;
- (c) foreign currency translation reserve;
 - (d) general reserves;
 - (e) cumulative unrealised gains or losses on hedges⁷ offsetting gains or losses included in Level 3 EC (such as movements in the currency value of foreign-currency-denominated hedging instruments that offset movements in foreign-currency-denominated items recognised in the foreign currency translation reserve). This includes fair value gains or losses on derivatives representing effective economic hedges of assets; and

⁷ This includes cumulative unrealised gains or losses on effective cash flow hedges as defined in Australian Accounting Standards.

- (f) any other gains and losses in accumulated comprehensive income and other disclosed reserves that may be specified by APRA in writing.
20. Revaluation of property holdings may be included as part of other disclosed reserves only if:
- (a) the property is owned by the Level 3 group;
 - (b) the property represents only land and buildings;
 - (c) the property is readily available to be sold. A property need not be scheduled for sale, nor need a sale be intended. However, such a property must be capable of being readily sold within six months were a decision made to sell the property;
 - (d) the reserves are shown as a component of equity in audited published financial accounts of the Level 3 group;
 - (e) the revaluations are reliable, in accordance with Australian Accounting Standards, and subject to audit or review consistent with **Australian Auditing and Assurance Standards**. An investment property must be measured at fair value in accordance with Australian Accounting Standards; and
 - (f) the amount of reserves incorporates the full effect of any fair value gains or losses and any gains or losses on hedges offsetting revaluations of the property (owner-occupied property and investment property) included in the reserves.
21. Paragraph 20 does not apply to property holdings held at fair value by life companies (**LI**s) in the Level 3 group nor to any property held at fair value, in accordance with written legal agreements, by the Level 3 group on behalf of third parties, even if the assets are held in the name of a **Level 3 institution** in the group.

Securitisation deconsolidation principle

22. Where a Level 3 institution in the Level 3 group participates in a **securitisation** that meets APRA's operational requirements for regulatory capital relief under *Prudential Standard APS 120 Securitisation* (APS 120) in accordance with the principles set out in *Prudential Standard 3PS 110 Capital Adequacy* (3PS 110), the **securitisation SPVs** holding securitised assets may be treated as non-consolidated independent third parties for the purpose of determining Level 3 EC, irrespective of whether the SPVs (or their assets) are consolidated for accounting purposes.

Intra-group capital transactions

23. The matters APRA may consider in assessing whether a component of capital resulting from intra-group transactions within the Level 3 group or, where applicable, the **wider conglomerate group** to which a Level 3 group belongs,

does not represent a genuine contribution to financial strength include, but are not limited to, whether a component of capital:

- (a) is clearly supplied from debt raised by members of the group;
- (b) results from intra-group transactions with no economic substance;
- (c) is contributed by members of the group using funding sourced, directly or indirectly, from the Level 3 group itself; or
- (d) is contributed by members of the group and the funding of which contains cross-default clauses that would be triggered as a result of Level 3 institutions in the Level 3 group failing to meet any servicing obligations.

Holding of capital instruments in Level 3 institutions by other Level 3 institutions

24. Capital instruments of a Level 3 group that are held as direct investments by a vehicle⁸ subject to consolidation within the group's financial statements in accordance with Australian Accounting Standards may be included in Level 3 EC only if:
- (a) the Level 3 group (or relevant vehicle) did not fund the acquisition of the capital instruments (i.e. acquisition of capital instruments is funded by third parties such as life insurance policyholders or other third party investors);
 - (b) the risk and rewards associated with the investments are borne primarily by third parties; and
 - (c) the Level 3 group can demonstrate to APRA, if required, that decisions to acquire or sell such capital instruments are made independently of the issuer of the capital instruments and in the interests of the third parties who primarily bear the risks and rewards of the investments in the instruments.
25. Direct investments in shares of a Level 3 Head by a special purpose vehicle (SPV) (e.g. a trust) established under a share-based employee remuneration scheme may be included in Level 3 EC only if:
- (a) the shares issued to the SPV represent ordinary shares of the Level 3 Head;
 - (b) the amount included in Level 3 EC is matched by an equivalent charge to profit and loss of the Level 3 group for expensing the issue or funding the acquisition of ordinary shares by the vehicle; and
 - (c) the ordinary shares issued cannot be converted to payment in another form (e.g. cash).

⁸ These vehicles exclude any special purpose vehicle, such as a trust, involved with employee share-based remuneration schemes.

For the purposes of measuring Level 3 EC, the SPV holding such shares must be excluded from the Level 3 group. As a consequence, any associated change in the fair value of the shares held by an SPV must be excluded from Level 3 EC.

26. If the requirements in paragraphs 24 and 25 are not satisfied, the relevant capital instruments must be treated as holdings of own capital instruments and deducted from Level 3 EC.

Adjustments and exclusions

27. APRA may, by notice in writing to a Level 3 Head, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to the Level 3 Head.⁹

⁹ Refer to subsection 11AF(2) of the Banking Act, subsection 32(3D) of the Insurance Act and subsection 230A(4) of the Life Insurance Act.

Attachment A**Criteria for classification as paid-up ordinary shares**

1. To be classified as paid-up ordinary shares in Level 3 EC, an instrument must satisfy the following criteria:
 - (a) the instrument represents the most subordinated claim in liquidation of the issuer;
 - (b) the instrument holder is entitled to a claim on the residual assets that is proportional to its share of issued capital, after all senior claims have been repaid in liquidation (i.e. there is an unlimited and variable claim, not a fixed or capped claim);
 - (c) the principal amount of the instrument is perpetual (i.e. it has no maturity date) and is never repaid outside of liquidation (other than discretionary repurchases subject to APRA approval);
 - (d) the issuer, and any other Level 3 institution in the Level 3 group, does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled and the statutory or contractual terms of the instrument do not include any feature that might give rise to such an expectation;
 - (e) distributions on the instrument are paid out of distributable items (retained earnings included) of the issuer, and the terms of the instrument do not provide for payment to investors other than in the form of a cash payment. The level of distributions must not be tied or linked to the amount paid up at issuance, or to the credit standing of the issuer, and must not be subject to a contractual cap, except to the extent that restrictions applied to the payment of distributions are in accordance with 3PS 110 or relevant industry-specific Prudential Standards¹⁰;
 - (f) there are no circumstances under which the distributions are obligatory. Non-payment of a distribution does not trigger any restrictions on the issuer or any other Level 3 institution in the Level 3 group. Any waived distributions are non-cumulative (i.e. they are not required to be made up by the issuer at a later date). Non-payment of distributions must not be an event of default of the issuer or of any other Level 3 institution in the group;
 - (g) distributions are paid only after all legal and contractual obligations have been met and payments on more senior instruments have been made. There are no preferential distributions, including in respect of other elements classified as Level 3 EC;

¹⁰ These are: *Prudential Standard APS 110 Capital Adequacy*, *Prudential Standard GPS 110 Capital Adequacy* and *Prudential Standard LPS 110 Capital Adequacy*.

- (h) the instruments take the first and proportionately greatest share of any losses as they occur.¹¹ Within Level 3 EC, each instrument absorbs losses on a going concern basis proportionately, and *pari passu*, with all the other instruments included in Level 3 EC;
 - (i) only the paid-up amount of the instrument, irrevocably received by the issuer, is recognised as equity capital (i.e. it is not recognised as a liability) for determining balance sheet insolvency;
 - (j) the paid-up amount of the instrument is classified as equity under Australian Accounting Standards;
 - (k) the instrument is directly issued by the issuer, and, except where otherwise permitted in this Prudential Standard, the issuer, any other Level 3 institution in the Level 3 group, or any related entity¹², cannot have purchased or directly or indirectly¹³ funded the purchase of the instrument;
 - (l) the paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of the issuer, another Level 3 institution in the Level 3 group or a related entity¹⁴ or subject to any other arrangement that legally or economically enhances the seniority of the claim. The instrument may not be subject to netting or offset claims on behalf of the holder or the issuer of the instrument;
 - (m) the instrument is only issued with the approval of the owners of the issuer, either given directly by the owners or, if permitted by applicable law, given by the Board or by other persons duly authorised by the owners; and
 - (n) the instrument is clearly and separately disclosed on the issuer's financial statements and the Level 3 group's consolidated financial statements. Disclosure must be in line with the frequency with which the group publishes its financial results.
2. Where an instrument is subject to the laws of a jurisdiction other than Australia or its territories, APRA may require the Level 3 Head to provide an independent expert opinion, addressed to APRA by a firm or practitioner of APRA's choice and at the expense of the Level 3 group, confirming that the instrument meets all or any of the criteria applied to capital instruments in this Prudential Standard.

¹¹ In cases where capital instruments have a permanent write-off feature, this criterion is still deemed to be met by ordinary shares.

¹² A related entity is a member of the wider conglomerate group to which the Level 3 group belongs or an entity over which the Level 3 group exercises control or significant influence. This does not preclude a member of the wider conglomerate group (except for a Level 3 institution) from holding the instrument where the instrument is directly issued by the Level 3 institution to that member of the wider conglomerate group.

¹³ This excludes full recourse lending to a borrower to fund the purchase of a well-diversified and well-collateralised portfolio that may include the capital instrument.

¹⁴ Refer to footnote 12.

Attachment B

Regulatory adjustments

General rules for regulatory adjustments

1. In determining the size of deductions from Level 3 EC, items must be valued on the same basis as a Level 3 group's balance sheet valuations.
2. A Level 3 Head that finds it operationally difficult to look through and monitor the exact exposure to equity and other capital instruments held by the Level 3 group in institutions, including through holdings of indexed securities, may apply to APRA to use a proxy approach for determining the amount of exposures to deduct. APRA may allow a Level 3 Head to apply an annual estimate of the amount to be deducted where the Level 3 Head can demonstrate that it can obtain details, at least annually, of the proportion of the group's exposures to financial and commercial institutions (such as an indexed security) comprised of equity and other exposures of a capital nature. Where a Level 3 Head cannot meet this requirement, it must deduct the full value of the group's indirect exposures.
3. For the purposes of deducting:
 - (a) equity exposures; and
 - (b) securitisation exposures,a Level 3 group may net any specific provisions raised against the relevant exposures or holdings before making the necessary deductions from Level 3 EC.
4. Where a regulatory adjustment does not refer to one or more specific **industry blocks**¹⁵, a Level 3 group must apply a consolidated Level 3 group basis to determine the regulatory adjustments.
5. Where a regulatory adjustment refers to one or more specific industry blocks, the regulatory adjustment must only be made for institutions located in those blocks. Regulatory adjustments specifically referring to one or more specific industry blocks must exclude exposures which are eliminated on consolidation of the Level 3 group. The regulatory adjustment in paragraph 38 of this Attachment must be determined on a legal entity basis.
6. For the ADI and GI blocks, reference to the block must be understood to mean the ADI Level 2 group or general insurance Level 2 group where applicable and the **Level 1** institutions¹⁶ and equivalent overseas institutions otherwise.

¹⁵ The industry blocks are: the **ADI block**; the **GI block**; the **LI block**; the **Super block**; the **FM block**; and the **OA block**.

¹⁶ Or the ELE where applicable.

Equity holdings and other capital support provided to third party financial institutions¹⁷ (ADI, FM and OA blocks only)

7. Unless otherwise indicated, institutions included in the ADI block must deduct direct, indirect¹⁸ and synthetic equity exposures, guarantees and other forms of capital support, and holdings of Additional Tier 1 Capital and Tier 2 Capital instruments¹⁹ in ADIs and equivalent overseas deposit-taking institutions and their subsidiaries²⁰, insurance companies and other financial institutions. This includes:
- (a) equity exposures, guarantees and other forms of capital support held in the banking book;
 - (b) net long positions²¹ in equity held in the trading book (refer to *Prudential Standard APS 116 Capital Adequacy: Market Risk*); and
 - (c) underwriting positions in equity held for more than five working days.

An institution in the ADI block is not required to deduct:

- (d) equity exposures in ADIs and equivalent overseas deposit-taking institutions and their subsidiaries, insurance companies and other financial institutions held, in accordance with written legal agreements, by the Level 3 group on behalf of third parties, even if the assets are held in the name of a Level 3 institution in the group;
 - (e) underwriting positions in equities held for five working days or less; and
 - (f) equity exposures held in other Level 3 institutions in the Level 3 group.
8. Level 3 institutions included in the OA block or the FM block must apply a similar approach as outlined in paragraph 7 of this Attachment to equity

¹⁷ Financial institution includes any institution engaged substantively in one or more of the following activities – banking; leasing; issuing credit cards; portfolio management (including asset management and funds management); management of securitisation schemes; equity and/or debt securities, futures and commodity trading and broking; custodial and safekeeping services; insurance (both general and life) and similar activities that are ancillary to the conduct of these activities. A financial institution includes any non-operating holding company authorised under the Banking Act or the Insurance Act or registered under the Life Insurance Act or overseas equivalent non-operating holding company.

¹⁸ Indirect holdings represent exposures that will result in a loss to the Level 3 group substantially equivalent to any loss in the direct holding. This excludes, for example, full recourse lending to a borrower to purchase a well-diversified and well-collateralised portfolio that may include the relevant exposures.

¹⁹ Additional Tier 1 Capital and Tier 2 Capital are as defined in APS 111. For Level 3 institutions in the ADI block, exclude from this deduction any holdings of Additional Tier 1 Capital or Tier 2 Capital already deducted by that institution from the same tier of capital through the corresponding deduction approach (refer to APS 111).

²⁰ ‘Subsidiaries’ has the meaning given in the *Corporations Act 2001*.

²¹ ‘Net long positions’ are the gross long positions net of the short positions in the same underlying exposures where the maturity of the short positions either match the maturity of the long positions or have residual maturities of at least one year. They include netting positions in physical instruments and derivatives over the same underlying exposure (including those associated with looking through holdings of index securities).

holdings and other capital support provided to third party financial institutions. References to the banking book must be read as references to the Level 3 institution's balance sheet, and paragraph 7(b) of this Attachment does not apply.

9. Equity holdings include:
 - (a) equity exposures (as defined in paragraphs 49 to 52 inclusive of *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113)) and, in the case of an APRA-regulated institution or an equivalent overseas institution, holdings of debt instruments issued by the institution or other facilities that qualify as regulatory capital for the issuer. Investments include indirect holdings such as holdings of units in a trust; and
 - (b) equity exposures including any portion of current year earnings or retained earnings that represents any amount deriving from the Level 3 group's share of undistributed profit or loss in an associate under equity accounting that is reflected in the value of equity investments in associates.
10. For the purposes of this Prudential Standard, the amount of equity exposures (as defined in paragraphs 49 to 52 inclusive of APS 113) and any other capital support that must be deducted from capital is the book value of the equity exposure or other capital support, including any amount by which they have been revalued. Any intangible component (particularly goodwill) included in the valuation of equity exposures or other capital support must be deducted from Level 3 EC.
11. In considering whether a facility (including a guarantee) provided to a party other than a Level 3 institution²² represents capital support, APRA will have regard to, amongst other things, whether:
 - (a) the facility represents a recognised capital instrument or is otherwise accepted as standing in place of capital required to be held by the institution; or
 - (b) the provider of the facility is subordinated to other creditors, and the facility is not otherwise captured by provisions in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* or APS 113 that consider the level of subordination in determining capital requirements for such facilities.
12. In the event that a facility covered in paragraph 11 of this Attachment represents a form of capital support, it must be considered for the purposes of this Prudential Standard to form part of a Level 3 group's equity holdings.

²²

This does not apply to guarantees provided to non-related **RSEs** or **RSE licensees**.

Holdings of own capital instruments

13. Unless otherwise indicated, a Level 3 group must deduct holdings of the Level 3 Head's own capital instruments, whether held directly or indirectly²³, unless otherwise exempted in writing by APRA or unless eliminated under Australian Accounting Standards. This deduction must include any capital instruments that a Level 3 institution in the group could be contractually obliged to purchase. The group must also deduct all of the unused portion of any trading limit agreed with APRA by Level 3 institutions in the group.
14. Unless otherwise indicated, the gross long positions of own capital instruments may be deducted net of short positions in own capital instruments only if the short positions involve no counterparty risk. A Level 3 group must look through holdings of index securities to determine exposures of the Level 3 Head's own ordinary shares to be deducted.²⁴
15. For the purposes of this Prudential Standard, a Level 3 institution may, as a result of membership of a dealer panel, trading or other activities agreed with APRA, undertake limited purchases of the Level 3 Head's own ordinary shares. Such purchases are subject to a limit as agreed with APRA, and the amount equal to the limit (or alternatively any actual holdings plus unused limit) must be deducted from Level 3 EC. This requirement does not apply to holdings of the Level 3 Head's own ordinary shares in accordance with paragraph 16 of this Attachment.
16. The Level 3 group must exclude from paragraphs 13 and 14 of this Attachment any holdings of the Level 3 Head's own ordinary shares which are held, in accordance with written legal agreements, by the group on behalf of third parties, even if the assets are held in the name of a Level 3 institution in the group. These ordinary shares held on behalf of third parties must be included in Level 3 EC where they are not already included.

Regulatory adjustments to Level 3 eligible capital

17. A Level 3 group must make the following regulatory adjustments to determine Level 3 EC, having regard to paragraphs 1 to 6 inclusive of this Attachment.

Asset impairment

18. A Level 3 group must deduct any identified impairment of an asset where the impairment has not already been taken into account in profit and loss.

Assets under a fixed or floating charge (GI, LI, Super, FM and OA blocks only)

19. Institutions included in the GI block, the LI block, the Super block, the FM block or the OA block must deduct all assets that are under a fixed or floating

²³ Refer to footnote 18.

²⁴ Gross long positions in own ordinary shares resulting from holdings of index securities may be netted against short positions in own ordinary shares resulting from short positions in the same underlying index. In such cases, short positions may involve counterparty risk.

charge²⁵, mortgage or other security to the extent of the indebtedness secured on those assets. This deduction may be reduced by the amount of any liability for the charge that is recognised on the institutions's balance sheet.

20. For GIs included in the GI block, where the security referred to in paragraph 19 of this Attachment exclusively supports the GI's insurance liabilities, the deduction only applies to the amount by which the fair value of the charged assets exceeds the GI's supported insurance liabilities. These insurance liabilities are to be valued in accordance with GPS 320.

Cash flow hedge reserve

21. A Level 3 group must eliminate the amount of the cash flow hedge reserve that relates to the hedging of items that are not recorded at fair value on the balance sheet (including projected cash flows).²⁶

Covered bonds excess assets in cover pools (ADI block only)

22. Institutions included in the ADI block must deduct the covered bonds excess assets in cover pools in accordance with APS 111, Attachment D.

Deferred tax assets and deferred tax liabilities

23. A Level 3 group must deduct from its Level 3 EC the net amount of its:

- (a) deferred tax assets; less
- (b) deferred tax liabilities.

A Level 3 group must net these items on a consistent basis for the purposes of this Prudential Standard. In the event that deferred tax liabilities exceed the amount of deferred tax assets, the excess cannot be added to Level 3 EC (i.e. the net deduction is zero).

24. Netting of deferred tax assets and deferred tax liabilities must only be applied where:
 - (a) a Level 3 institution in the Level 3 group has a legally enforceable right to set-off current tax assets against current tax liabilities where they relate to income taxes levied by the same taxation authority and the taxation authority permits the institution to make or receive a single net payment; and
 - (b) the deferred tax assets and deferred tax liabilities relate to income taxes levied by the same authority on either:
 - (i) the same taxable Level 3 institution in the Level 3 group; or

²⁵ 'Charge' means a charge created in any way and includes a mortgage or an agreement to give or execute a charge or mortgage, whether upon demand or otherwise.

²⁶ Any gains on hedges are to be deducted and any losses on hedges added back.

- (ii) different taxable Level 3 institutions in the Level 3 group for which group policies and procedures have been established that provide for the relevant institutions to settle current tax assets and liabilities on a net basis, or to realise the assets and liabilities simultaneously, in each future period in which significant amounts of deferred tax assets or liabilities are to be settled or recovered; and
- (iii) for Level 3 institutions in the Level 3 group incorporated outside Australia for which:
 - (A) it is claimed current tax assets and liabilities will be settled on a net basis; and
 - (B) netting may have a material impact on any amount of deferred tax assets the Level 3 group may be required to deduct from its Level 3 EC,

the group must have written opinions from relevant external auditors and legal advisors that the relevant tax authorities allow, or would allow, netting of deferred tax assets and deferred tax liabilities. A Level 3 Head must provide relevant written auditor or legal opinions to APRA, if requested.

25. A Level 3 Head must:

- (a) ensure that the Level 3 group has procedures in place to monitor changes in relevant laws and taxation practices that may affect the written opinions it is required to obtain covering netting of deferred tax assets and deferred tax liabilities; and
- (b) ensure that the written opinions are updated in the event of changes in laws or taxation practices overseas that could materially impact on overseas taxation authorities continuing to allow netting of deferred tax assets and deferred tax liabilities.

26. A Level 3 group must exclude from the deduction referred to in paragraph 23 of this Attachment any deferred tax assets and deferred tax liabilities attributable to assets and liabilities held by the Level 3 group on behalf of life insurance policyholders or beneficiaries of an RSE within the RSE licensee's business operations, even if the assets and liabilities are held in the name of a Level 3 institution in the group.

Difference between the adjusted policy liabilities and the sum of policy liabilities and policy owners' retained profits (LI block only)

27. Institutions included in the LI block must deduct the difference between the adjusted policy liabilities and the sum of the policy liabilities and policy owners' retained profits disclosed in the statutory accounts together with any tax effects that would result from these adjustments. This adjustment is determined in accordance with *Prudential Standard LPS 112 Capital Adequacy*:

Measurement of Capital (LPS 112), Attachment B and can be positive or negative.

Equity holdings and other capital support provided to third party commercial (non-financial) institutions (ADI block only)

28. Institutions included in the ADI block must deduct third party equity holdings and other capital support provided to commercial (non-financial) institutions in accordance with APS 111, Attachment D. Equity exposures to other Level 3 institutions in the Level 3 group must be excluded for this purpose.

Fair value adjustments

29. A Level 3 group must deduct any amount required by APRA in writing where APRA considers that fair values on the balance sheet are not prudent or reliable.

Fair value gains and losses arising from changes in own creditworthiness

30. A Level 3 group must eliminate all unrealised gains and losses that have resulted from changes in the fair value of liabilities (including capital instruments) due to changes in the own creditworthiness of the group or of a Level 3 institution in the group.

Goodwill and other intangibles

31. A Level 3 group must deduct the following net of any associated deferred tax liability that would be extinguished if the assets involved become impaired or derecognised under Australian Accounting Standards:
 - (a) goodwill and any other intangible assets²⁷ arising from an acquisition, net of adjustments to profit or loss reflecting any changes arising from 'impairment' of goodwill; and
 - (b) other intangible assets net of adjustments to profit or loss reflecting amortisation and impairment. Intangible assets are as defined in Australian Accounting Standards and include capitalised expenses, capitalised transaction costs and mortgage servicing rights. These expenses include:
 - (i) loan/lease origination/broker fees and commissions that are capitalised as an asset which are to be set off against the balance of upfront loan/lease origination/broker fees and commissions associated with the lending portfolios that are treated as deferred income and recognised as a liability. The positive balance of the net loan/lease origination/broker fees and commissions must be deducted from Level 3 EC. A negative balance may be added to Level 3 EC provided the net deferred income satisfies the criteria in

²⁷ This includes goodwill and intangibles attributable to investments in joint ventures and associates. For the purposes of this Prudential Standard, a joint operation (as defined under *Australian Accounting Standard AASB 11*) is to be treated as a joint venture.

this Prudential Standard. Otherwise, a negative balance must not be added to capital;

- (ii) costs associated with debt raisings and other similar transaction-related costs that are capitalised as an asset;
 - (iii) costs associated with issuing capital instruments if not already charged to profit and loss;
 - (iv) capitalised information technology software costs;
 - (v) start-up and other establishment costs of a securitisation that are capitalised as an asset, and are to be set-off against the balance of fee income relating to securitisation schemes recognised and deferred as a liability. Any positive net balance must be deducted from Level 3 EC (refer to APS 120).²⁸ Any up-front fee income received in excess of the capitalised securitisation establishment cost may be added to Level 3 EC provided it meets the criteria in paragraph 17 of this Prudential Standard; and
 - (vi) other capitalised expenses including capitalised expenses of a general nature such as strategic business development initiatives. These also include, in addition to the above listed items, other forms of transaction costs and like costs that are required to be deferred/capitalised and amortised as part of the measurement of assets and liabilities under Australian Accounting Standards.
32. The balance of any transaction costs and like items that are capitalised and deferred as an asset must be netted off against the balance of any income deferred as a liability relating to the products giving rise to the capitalised transaction costs (i.e. only deferred costs and income in particular product portfolios may be netted). Any net balance of capitalised transaction costs must be deducted from Level 3 EC in accordance with this Prudential Standard. Any surplus of up-front fee income received over deferred costs may be included in Level 3 EC provided the up-front fee income received satisfies the criteria in paragraph 17 of this Prudential Standard. Otherwise, up-front fee income received must not be added to capital.
33. Exclude from paragraph 31 of this Attachment any goodwill and other intangible assets attributable to assets held, in accordance with written legal agreements, by the Level 3 group on behalf of third parties, even if the assets are held in the name of a Level 3 institution in the group.

Guarantees (ADI block only)

34. Institutions included in the ADI block must deduct any guarantee, or credit derivative covering a credit exposure of the group, that provides for a materiality threshold below which no payment will be made in the event of a loss.

²⁸ Reference to the ADI in APS 120 must be read as a reference to the Level 3 group, and reference to Common Equity Tier 1 Capital must be read as a reference to Level 3 EC.

Industry support schemes (ADI block only)

35. Institutions included in the ADI block must deduct any non-repayable loans advanced by another ADI under APRA's certified industry support arrangements in accordance with APS 111, Attachment D.

Investments in joint ventures and associates (GI and LI blocks only)

36. Institutions included in the GI block must deduct investments in joint ventures and associates in accordance with GPS 112, Attachment B. Joint ventures and associates which are Level 3 institutions of the Level 3 group must be excluded from this deduction.
37. Institutions included in the LI block must deduct investments in joint ventures and associates in accordance with LPS 112, Attachment B. Joint ventures and associates which are Level 3 institutions of the Level 3 group must be excluded from this deduction.

Operational risk reserves held within RSEs (Super block only)

38. A Level 3 group must include for each RSE licensee in Level 3 EC the operational risk reserves held by each RSE for whom the RSE licensee has been appointed as trustee to meet the operational risk financial requirement (ORFR) target amount as determined in accordance with *Prudential Standard SPS 114 Operational Risk Financial Requirement*. Any operational risk reserves in excess of the ORFR target amount included, in accordance with 3PS 110, in the determination of required capital for the Super block must not be included in Level 3 EC.

Reinsurance assets (GI and LI blocks only)

39. A general insurance Level 2 group, or, where none is present, the GIs on a standalone basis must deduct all reinsurance assets in accordance with GPS 112, Attachment B. This regulatory adjustment does not apply to equivalent overseas general insurers included in the GI block on a standalone basis unless the adjustment is required in the relevant jurisdiction.
40. Institutions included in the LI block must deduct all reinsurance assets in accordance with LPS 112, Attachment B.

Securitisation

41. A Level 3 group must deduct²⁹:
- (a) the value of securitisation exposures subject to capital deduction under APS 120;
 - (b) any increase in Level 3 EC arising from any gain on sale (refer to APS 120);

²⁹ Reference to the ADI in APS 120 must be read as a reference to the Level 3 group, and reference to Common Equity Tier 1 Capital must be read as a reference to Level 3 EC.

- (c) any capitalised expected future income relating to securitisation activities prior to it being irrevocably received; and
- (d) the difference between the book value and the value realised for transfers of exposures to a securitisation SPV where the realised value is less than the book value, unless the difference has been written off to the Level 3 group's profit and loss (refer to APS 120).

Shortfall in provisions for credit losses (ADI block only)

- 42. Institutions included in the ADI block must deduct the shortfall in the stock of eligible provisions under the IRB approach to credit risk in accordance with APS 111, Attachment D.

Specific provisions (ADI block only)

- 43. Institutions included in the ADI block must deduct specific provisions in accordance with APS 111, Attachment D.

Superannuation defined benefit funds

- 44. A Level 3 group must deduct any surplus in a defined benefit fund, of which a Level 3 institution in the group is an employer-sponsor, unless otherwise approved in writing by APRA. The surplus must be net of any associated deferred tax liability that would be extinguished if the assets involved become impaired or derecognised under Australian Accounting Standards. A Level 3 Head may apply to APRA to include a surplus as an asset for capital adequacy purposes where the Level 3 institution in the group that is the employer-sponsor is able to demonstrate unrestricted and unfettered access to a fund surplus in a timely manner. Subject to APRA approval, the surplus will no longer be required to be deducted from Level 3 EC.
- 45. A Level 3 group must deduct any deficit in a defined benefit superannuation fund of which a Level 3 institution in the group is an employer-sponsor and that is not already reflected in Level 3 EC.

Other adjustments

- 46. A Level 3 group must deduct any other deductions that Level 3 institutions in the group are required to make under any applicable Prudential Standard insofar as these deductions are not already reflected in Level 3 EC and do not disappear on consolidation.
- 47. A Level 3 group must make any further adjustments as determined by APRA in writing to the Level 3 Head.