Prudential Standard APS 111

Capital Adequacy: Measurement of Capital

Objectives and key requirements of this Prudential Standard

This Prudential Standard sets out the characteristics that an instrument must have to qualify as regulatory capital for an authorised deposit-taking institution (ADI) and the various regulatory adjustments to be made to determine total regulatory capital on both a Level 1 and Level 2 basis.

The ultimate responsibility for ensuring that an ADI's regulatory capital meets the requirements of this Prudential Standard rests with its Board of directors.

The key requirements of this Prudential Standard are that an authorised deposit-taking institution must:

- include in the appropriate category of regulatory capital (i.e. Common Equity Tier 1 Capital, Additional Tier 1 Capital or Tier 2 Capital) only those capital instruments that meet the detailed criteria for that category;
- ensure all regulatory capital instruments are capable of bearing loss on either a 'going-concern' basis (Tier 1 Capital) or a 'gone-concern' basis (Tier 2 Capital); and
- make certain regulatory adjustments to capital, mainly from Common Equity Tier 1 Capital, to determine total regulatory capital.

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Regulatory capital

19. Common Equity Tier 1 Capital consists of the sum of:

    (a) paid-up ordinary shares issued by an ADI that meet the criteria in Attachment B;

    (b) instruments issued by a mutually owned ADI that meet the criteria in paragraph 2 of Attachment K (mutual equity interests) up to the limit specified in paragraph 5 of Attachment K;

Attachment B — Criteria for classification as paid-up ordinary shares

1. To be classified as paid-up ordinary shares in Common Equity Tier 1 Capital, 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 member of a group to which the issuer belongs, 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 *Prudential Standard APS 110 Capital Adequacy* (APS 110);

   (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 member of the group to which the issuer belongs. 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 member of the group to which the issuer belongs;

   (g) distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. There are no preferential distributions, including in respect of other elements classified as Common Equity Tier 1 Capital;

   (h) the instruments take the first and proportionately greatest share of any losses as they occur. Within Common Equity Tier 1 Capital, each instrument absorbs losses on a going concern basis proportionately, and *pari passu*, with all the other instruments included in Common Equity Tier 1 Capital;

(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 relevant accounting standards;

(k) the instrument is directly issued by the issuer, and, except where otherwise permitted in this Prudential Standard, the issuer, any other member of a group to which the issuer belongs, or any related entity, cannot have purchased or directly or indirectly 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 or a related entity, 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, in any consolidated financial statements. Disclosure must be in line with the frequency with which an ADI, or group of which it is a member, publishes its financial results.

2. Where an instrument is subject to the laws of a jurisdiction other than Australia or its territories, the ADI must also ensure that the instrument satisfies all relevant qualifying criteria for Common Equity Tier 1 Capital under the laws of that jurisdiction. APRA may require the ADI to provide an independent expert opinion, addressed to APRA by a firm or practitioner of APRA's choice and at the expense of the ADI, confirming that the instrument meets all or any of the criteria applied to Common Equity Tier 1 Capital instruments in this Prudential Standard.

3. For the purposes of Attachment K, a reference in this Attachment (except in paragraphs 1(a), (b), (e) and (h)) to 'ordinary shares' is to be read as a reference to 'mutual equity interests'.

Attachment K — Mutual equity interests

1. Mutual equity interests may only be issued:

   (a) directly by an ADI; or

   (b) on conversion of an Additional Tier 1 or Tier 2 instrument in accordance with Attachments F and J of this Prudential Standard.

2. To be classified as a mutual equity interest, an instrument must satisfy all of the criteria in this Attachment and Attachment B, except that paragraphs 1(a), 1(b), 1(e) and 1(h) of Attachment B are to be read as follows:

   (a) the mutual equity interest represents a claim in liquidation of the issuer that is subordinate to all claims that may be made in relation to instruments that are included by the issuer as Additional Tier 1 or Tier 2 Capital instruments;

   (b) the holder of the mutual equity interest is entitled to a claim on the residual assets of the issuer after all senior claims and the aggregate subscription price paid for any member shares have been repaid in liquidation and that claim:

      (i) ranks equally and proportionately with all other mutual equity interests directly issued or created on conversion of Additional Tier 1 and Tier 2 Capital instruments in accordance with Attachments F and J; and

      (ii) is subject to a cap equal to the principal amount of the mutual equity interest, being:

         (A) if the mutual equity interest was issued directly, the subscription price of the mutual equity interest; and

         (B) if the mutual equity interest was created on conversion of Additional Tier 1 and Tier 2 Capital instruments, the nominal dollar value of the Additional Tier 1 or Tier 2 Capital instrument prior to conversion into the mutual equity interest;

   (e) distributions on the mutual equity interest are paid out of distributable items (including retained earnings) of the issuer, and the terms of the mutual equity interest 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 credit standing of the issuer, but may be calculated by reference to an external benchmark or index. Distributions on all mutual equity interests on issue cannot, in aggregate, exceed 50 per cent of the issuer's net profit after tax for the annual period in which the distributions are made. All distributions on mutual equity interests must be treated as dividends for the purposes of APS 110 and the issuer is subject to the restrictions applied to the payment of distributions in accordance with APS 110;

(h) each mutual equity interest absorbs losses on a going concern basis proportionately, and *pari passu*, with all other mutual equity interests included in Common Equity Tier 1 Capital.

3. Issue documentation and marketing material for mutual equity interests must clearly and prominently state that:

   (a) the mutual equity interest is not a deposit liability of the ADI;

   (b) the mutual equity interest is not covered by the Financial Claims Scheme and is not guaranteed by the Australian Government;

   (c) the mutual equity interest cannot be redeemed and the purchase price of a mutual equity interest will not be repaid;

   (d) the holder of a mutual equity interest may only be entitled to a claim on the issuing ADI's residual assets after other more senior claims (including Additional Tier 1 and Tier 2 instruments) have been paid; and

   (e) neither the issuer nor the holder of the mutual equity interest is allowed to exercise any contractual rights of set-off.

4. An ADI must obtain APRA's approval prior to issuing mutual equity interests, or Additional Tier 1 or Tier 2 instruments that convert to mutual equity interests in accordance with Attachments F and J. APRA may approve an issue under this paragraph.

5. All mutual equity interests on issue are included in Common Equity Tier 1 Capital up to a maximum limit calculated as the sum of the principal amount of the ADI's mutual equity interests (determined in accordance with paragraph 2(b)(ii) of this Attachment), being 15 per cent of the ADI's total Common Equity Tier 1 Capital.