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Dear Charles,

## **Draft Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and supervisory review**

The Australian Bankers' Association (ABA) welcomes the opportunity to comment on APRA's draft *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and supervisory review*. The ABA acknowledges the pressures placed on both regulators and ADIs by the ongoing implementation of Basel III, and other new regulations, and appreciates APRA's ongoing willingness to engage industry in this process.

The ABA and its members are broadly supportive of the draft CPG 110. APRA's approach of using the same guidance for ADIs and life and general insurance companies is a sensible development. The decision by APRA not to prescribe the format of the ICAAP document is welcomed by the ABA, along with APRA's decision not to stipulate the need for separate summary and report documents. The ABA also concurs with the logic behind APRA's comments that the ICAAP is an internal document for the Board, not for APRA. It would be helpful if APRA could provide an indication of the expected release date of the final CPG 110 and APRA's expectations of the timing of compliance by ADIs.

As stated, the ABA is broadly supportive of the draft CPG 110. However, we would like to raise a number of questions for APRA's consideration.

### **1. Level of detail prescribed to be presented to the Board**

The ABA acknowledges the need to provide the Board with a level of detail that allows it to fully understand and question the ICAAP Report and Summary. However, it is important to balance that requirement against including information that provides limited added value to the Board and could hinder the Board focusing on and challenging the key aspects of the ICAAP. The level of detail prescribed by APRA appears to exceed that which would typically be presented to an ADI's Board and seems more pitched at a management level. The ICAAP guidance would be enhanced by APRA more formally recognising the difference in the two perspectives and clarifying exactly what level of detail on which expects the Board.

Expanding on this point, it is the ABA's view that some of APRA's expectations relating to information contained in the ICAAP Report and Summary documents in paragraphs 43 and 49 are more consistent with the level of detail which should be provided to management. The level of prescribed detail also risks dominating the ICAAP to the extent that it effectively ceases to reflect the ADI's internal view of its capital adequacy. The ABA recommends that APRA review these paragraphs to ensure that the information contained in the ICAAP Summary and Report is limited to that which is meaningful to the Board and which will enable it to focus on and challenge the key aspects of the ICAAP.

For example, paragraph 43 specifies that the Summary Statement should include:

- a description of the procedures and persons involved in approving, reviewing and monitoring compliance with the ICAAP; and
- an outline of the procedures and persons responsible for the ongoing implementation of the ICAAP.

While this level of detail should be documented and understood by management, the ABA believes that the Board's engagement with these questions should focus on the process used by the Board to satisfy itself that the ICAAP will deliver outcomes consistent with the risk appetite set by the Board, rather than the detail employed by management.

Similarly, paragraphs 48 and 49 specify that the ICAAP Report should include:

- a description of key contractual terms of an ADI's capital instruments;
- a description of how quantitative results have been derived; and
- a reconciliation of economic and regulatory capital including explanation of the areas of difference and their impact on the result.

A description of the key contractual terms would contain a lot of detail, without providing any obvious added value to the Board, when these must, by definition, comply with the relevant prudential criteria. The ABA proposes that APRA's policy intent would be preserved if this requirement was removed or reframed as follows:

- A description of key differences between Additional Capital Instruments (i.e. Additional Tier 1 and Tier 2) and Common Equity Tier 1 Capital.

Highlighting the differences would focus the Board's attention more on the logic (and risks) of using non-Common Equity Tier 1 Capital – an outcome in line with the purpose of the ICAAP Report.

In respect to how quantitative results are derived, this should be addressed at a management level. The Board's concern should be limited to ensuring the proper processes are in place to ensure quantitative results are reviewed and assessed by suitable executives with the relevant expertise.

Additionally, the circumstances under which details of a reconciliation of economic and regulatory capital would be required are not clear. If it is APRA's desire that such a reconciliation (including areas of difference and their impact on the result) is provided in the ICAAP when economic capital suggests that the ADI should hold more capital than a regulatory requirement, it may be more effective for APRA to specify this in the CPG. Alternatively, if such detail were to be required under different circumstances, clarification of those circumstances would be of use to ADIs.

The general point that the ABA would like to stress is that it believes the integrity of the ICAAP as an internal document would be better preserved if APRA were less prescriptive on the detail and allowed ADIs more discretion to include or exclude the issues they deem appropriate in framing their view of the adequacy of the ADI's capital position. Being overly prescriptive risks reducing management's ability to highlight to the Board those issues perceived by management as being of the greatest importance to the ADI. To the extent that an ADI failed to adequately address some aspect of the ICAAP that APRA

deemed material, APRA always retains the power to raise these issues with the Board and management.

## 2. Strategy for maintaining adequate capital

Item (e) of Paragraph 24 of the guidance states that an ADI's strategy for maintaining adequate capital over time will typically take account of a range of capital-generating and capital-consuming factors, including the ADI's ability to remain adequately capitalised under a wide range of market and economic conditions, including severely stressed scenarios.

The ABA notes that a 'severe' level of stress is something which ADIs would typically associate with scenarios in which the initial impact of losses could be absorbed by the capital conservation buffer and/or the countercyclical buffers. The ABA would, therefore, recommend that item (e) of paragraph 24 be amended to include a reference to the availability of capital buffers to absorb losses. For example:

*"The need to ensure adequate immediate and projected capital coverage in a wide range of market and economic conditions, including stressed scenarios, over a reasonable period of time, taking into account the availability of the capital conservation and countercyclical buffers to absorb losses incurred during severe levels of stress."*

## 3. Trigger levels and related actions to manage capital

Paragraph 26 of the guidance states that 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 paragraph also states that the actions associated with the various triggers will ordinarily increase in intensity as capital surplus reduces. Paragraph 27 goes on to state that variation around target capital levels set in the ICAAP is acceptable as long as the regulated institution acts in accordance with the trigger points and actions set out in its ICAAP.

It is the ABA's view that the type of framework that appears to be contemplated in these paragraphs would lead to an overly rigid and inflexible capital management process. It is worth noting that some of the actions previously identified may not be available at the time because of market and other conditions. The actions used to manage capital at any point in time will depend upon the nature of the stress on capital adequacy, including the level of stress.

For these reasons, linking capital management actions too rigidly to trigger levels may actually hinder capital management. If defined actions are to be prescribed to particular triggers, it seems sensible to allow a range of actions to be used, to accommodate flexible and responsive reactive measures to be implemented. As an alternative approach, the ABA recommends that paragraphs 26 and 28 be amended to decouple capital triggers from the capital management actions. For example:

*26. 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.*

*28. APRA expects than an institution will contemplate a range of actions which may be used to protect its capital position. Actions will vary in intensity and will include.*

## 4. Other issues

Other issues that the ABA would like to raise for APRA's consideration are:

- Paragraph 19 (c) APS 110 (Final Version): The ABA had expected, in the draft CPG 110, that APRA would provide clarification on the ICAAP Report accuracy undertaking, in paragraph 19(c) of APS 110 (Final Version), to be given by the CEO of each ADI. Could APRA clarify and expand on

how this undertaking would be applied to an ADI's estimate of current and future Pillar 2 risk capital requirements given that all models used will involve a degree of judgement?

- Paragraph 35 (a) and (c) Re stress testing: “statistically generated scenarios” and “statistical factors” – The value of statistically generated scenarios, as opposed to hypothetical or historical scenarios is unclear. Can APRA expand on its reasoning behind the use of “statistically generated scenarios” and “statistical factors”?
- Paragraph 45 – “The annual ICAAP report details the outcomes of the implementation of these processes over the previous year” – “outcomes” is rather vague and not explained in paragraph 49. Is APRA able to provide clarity on this requirement, beyond that given in paragraph 18(b) in APS 110?
- Paragraph 52 (d) – “APRA will intervene at an early stage if a regulated institution’s capital shows any signs of falling below PCR”. “Early stage” and “any sign” are open ended. Can APRA provide clarity on this proposal, any safeguards it intends implementing and how it relates to the current proposals on expanding APRA’s crisis management powers?
- Paragraphs 56 & 57 – The ABA notes that the capital conservation buffer and countercyclical buffer will not officially apply until 1 January 2016. However, there is no reference to this date in CPG 110.

Yours sincerely,



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Tony Burke