



Prudential Standard APS 110

Capital Adequacy

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires an authorised deposit-taking institution (ADI) to maintain adequate capital, on both a Level 1 and Level 2 basis, to act as a buffer against the risk associated with its activities.

The ultimate responsibility for the prudent management of capital of an ADI rests with its Board of directors. The Board must ensure the ADI maintains an appropriate level and quality of capital commensurate with the type, amount and concentration of risks to which the ADI is exposed.

The key requirements of this Prudential Standard are that an ADI and any Level 2 group must:

- have an Internal Capital Adequacy Assessment Process;
- maintain required levels of regulatory capital;
- operate a capital conservation buffer and, if required, a countercyclical capital buffer;
- inform APRA of any adverse change in actual or anticipated capital adequacy; and
- seek APRA's approval for any planned capital reductions.

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Authority

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

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**) with the exception of:
 - (a) a **foreign ADI**, which must, however, be subject to comparable capital adequacy standards in its home country; or
 - (b) a **purchased payment facility provider (PPF provider)**.
3. A reference to an ADI in this Prudential Standard, unless otherwise indicated, is a reference to:
 - (a) an ADI on a **Level 1** basis; and
 - (b) a **group** of which an ADI is a member on a **Level 2** basis.
4. If an ADI to which this Prudential Standard applies is:
 - (a) the holding company for a group, the ADI must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable; or
 - (b) a **subsidiary** of an authorised **non-operating holding company (authorised NOHC)**, the authorised NOHC must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable.

Interpretation

5. Terms that are defined in *Prudential Standard APS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.
6. Where this Prudential Standard provides for APRA to exercise a power or discretion, this power or discretion will be exercised in writing.
7. In this Prudential Standard, unless the contrary intention appears, a reference to an Act, Regulations or Prudential Standard is a reference to the Act, Regulations or Prudential Standard as in force from time to time.

Definitions

8. The following definitions are used in this Prudential Standard:
 - (a) **IRB ADI** – means an ADI which has been approved by APRA to use the Internal Ratings-based Approach to credit risk;
 - (b) **[simple ADI** – means a standardised ADI which satisfies the eligibility criteria for inclusion within the simplified framework]; and

- (c) standardised ADI – means an ADI which has not been approved by APRA to use the Internal Ratings-based Approach to credit risk.

Adjustments and exclusions

9. APRA may adjust or exclude a prudential requirement in this Prudential Standard in relation to one or more ADIs or authorised NOHCs.¹

Previous exercise of discretion

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

Responsibility for capital management

11. Capital is the cornerstone of an ADI's financial strength. It supports an ADI's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enables the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved.
12. Capital management must be an integral part of an ADI's risk management, by aligning its risk appetite and risk profile with its capacity to absorb losses.
13. The Board of directors (**Board**)² of an ADI has a duty to **ensure** that the ADI maintains a level and quality of capital commensurate with the type, amount and concentration of risks to which the ADI is exposed from its activities. In doing so, the Board must have regard to any prospective changes in the ADI's risk profile and capital holdings.
14. An ADI that is a member of a group may be exposed to risks, including reputational and contagion risk, through its association with other members of the group. Problems arising in other group members may compromise the financial and operational position of the ADI. The **Board**, in determining the capital adequacy of the ADI at Level 1, must have regard to:
- (a) risks posed to the ADI by other members of the group, including the impact on the ability of the ADI to raise funding and additional capital should the need arise;
 - (b) obligations, both direct and indirect, arising from the ADI's association with group members that could give rise to a call on the capital of the ADI; and
 - (c) the ability to freely transfer capital (including situations where the group is under financial or other forms of stress) from members of the group to

¹ Refer to subsection 11AF(2) of the Banking Act.

² Unless otherwise indicated, a reference to the Board of an ADI in this Prudential Standard is also a reference, where relevant, to the Board of the entity that heads the Level 2 group.

recapitalise the ADI or other members of the group. This includes consideration of:

- (i) the integration of business operations within the group;
- (ii) the importance of members of the group to the group;
- (iii) the impact of cross-border jurisdictional issues;
- (iv) differences in legislative and regulatory requirements that may apply to group members; and
- (v) the impact of taxation and other factors on the ability to realise investments in, or transfer surplus capital from, group members.

Internal Capital Adequacy Assessment Process

15. An ADI must have an **Internal Capital Adequacy Assessment Process (ICAAP)** that must:
 - (a) be adequately documented, with the documentation made available to APRA on request; and
 - (b) be approved by the Board initially, and when significant changes are made.
16. An ADI's ICAAP must be appropriate to the ADI's size, business mix and complexity of its operations and group structure.
17. An ADI that is part of a group may rely on the ICAAP of the group provided that the Board of the ADI is satisfied that the group ICAAP meets the criteria in paragraph 18 of this Prudential Standard in respect of the ADI.
18. The ICAAP must include at a minimum:
 - (a) adequate policies, procedures, systems, controls and personnel to identify, measure, monitor and manage the risks arising from the ADI's activities on a continuous basis, and the capital held against such risks;
 - (b) a strategy for ensuring adequate capital is maintained over time, including specific capital targets set out in the context of the ADI's risk profile, the ADI's risk appetite and **regulatory capital** requirements. This includes plans for how target levels of capital are to be met and the means available for sourcing additional capital where required;
 - (c) actions and procedures for monitoring the ADI's compliance with its regulatory capital requirements and capital targets. This includes the setting of triggers to alert management to, and specified actions to avert and rectify, potential breaches of these requirements;
 - (d) stress testing and scenario analysis relating to potential risk exposures and available capital resources;

- (e) processes for reporting on the ICAAP and its outcomes to the Board and senior management of the ADI, and for ensuring that the ICAAP is taken into account in making business decisions;
 - (f) policies to address the capital impact of material risks not covered by explicit regulatory capital requirements; and
 - (g) an ICAAP summary statement as defined in paragraph 19 of this Prudential Standard.
19. The ICAAP summary statement is a high-level document that describes and summarises the capital assessment and management processes of the ADI. It must outline at a minimum the aspects of the ICAAP listed in paragraphs 18(a) to 18(f) of this Prudential Standard. The ICAAP summary statement must also include:
- (a) a statement of the objectives of the ICAAP, the expected level of financial soundness associated with the capital targets and the time horizon over which the ICAAP applies;
 - (b) a description of the key assumptions and methodologies utilised by the ADI in its ICAAP, including stress testing and scenario analysis;
 - (c) triggers for reviewing the ICAAP in light of changes to business operations, regulatory, economic and financial market conditions, group structure and other factors affecting the ADI's risk profile and capital resources;
 - (d) a summary of the ADI's policy for reviewing its ICAAP, including who is responsible for the review, details of the frequency and scope of the review, and mechanisms for reporting on the review and its outcomes to the Board and senior management;
 - (e) a description of the basis of measurement of capital used in the ICAAP, and an explanation of the differences where this basis differs from that used for regulatory capital; and
 - (f) references to supporting documentation and analysis as relevant.
20. An ADI must ensure that its ICAAP is subject to regular and robust review by appropriately qualified persons who are operationally independent of the conduct of capital management. The frequency and scope of the review must be appropriate to the ADI, having regard to its size, business mix, complexity of its operations and group structure, and the nature and extent of any changes that have occurred or are likely to occur in its business profile or its risk appetite. A review must be conducted at least every three years. The review must be sufficient to reach a view on whether the ICAAP is adequate and effective.
21. An ADI must, on an annual basis, provide a report on the implementation of its ICAAP to APRA (ICAAP report). A copy of the ICAAP report must be provided to APRA no later than three months from the date on which the report has been prepared.

22. The ICAAP report must include:
- (a) detailed information on current and three-year projected capital levels relative to minimum regulatory capital requirements and target levels;
 - (b) detailed information on the actual outcomes of applying the ICAAP over the period, relative to the planned outcomes in the previous ICAAP report (including analysis of the ADI's actual capital position relative to minimum regulatory capital requirements and capital targets and actual versus planned capital management actions);
 - (c) a description of material changes to the ICAAP since the previous ICAAP report;
 - (d) detail and outcomes of stress testing and scenario analysis used in undertaking the ICAAP;
 - (e) a breakdown of capital usage over the planning horizon, as relevant, by material:
 - (i) business activity;
 - (ii) group members;
 - (iii) geographic spread of exposures; and
 - (iv) risk types;
 - (f) an assessment of anticipated changes in the ADI's risk profile or capital management processes over the planning horizon;
 - (g) details of any review of the ICAAP since the previous ICAAP report, including any recommendations for change and how those recommendations have been, or are being, addressed; and
 - (h) references to supporting documentation and analysis as relevant.
23. The ICAAP report submitted to APRA by the ADI must be accompanied by a declaration approved by the Board and signed by the CEO stating whether:
- (a) capital management has been undertaken by the ADI in accordance with the ICAAP over the period and, if not, a description of, and explanation for, deviations;
 - (b) the ADI has assessed the capital targets contained in its ICAAP to be adequate given the size, business mix and complexity of its operations and, at Level 2, given the location of operations of group members and the complexity of the group structure; and
 - (c) the information included in the ICAAP report is accurate in all material respects.

Minimum risk-based capital adequacy requirements

24. APRA will determine **prudential capital requirements (PCRs)** for an ADI. The PCRs, expressed as a percentage of total risk-weighted assets, will be set by reference to **Common Equity Tier 1 Capital, Tier 1 Capital** and **Total Capital**. PCRs may be determined at Level 1, Level 2 or both.
25. The minimum PCRs that an ADI must maintain at all times are:
- (a) a Common Equity Tier 1 Capital ratio of 4.5 per cent;
 - (b) a Tier 1 Capital ratio of 6.0 per cent; and
 - (c) a Total Capital ratio of 8.0 per cent.

APRA may determine higher PCRs for an ADI and may change an ADI's PCRs at any time.

26. An ADI must maintain risk-based capital ratios above its PCRs at all times. Risk-based regulatory capital ratios are to be calculated in accordance with Attachment A to this Prudential Standard.

Capital conservation buffer

27. An ADI must hold a capital conservation buffer above the PCR for Common Equity Tier 1 Capital.
28. The capital conservation buffer is 2.5 per cent of the ADI's total risk-weighted assets, unless determined otherwise by APRA. The sum of the Common Equity Tier 1 PCR plus the capital conservation buffer determined by APRA will be no less than 7.0 per cent of the ADI's total risk-weighted assets.
29. Any amount of Common Equity Tier 1 Capital required to meet an ADI's PCR for Tier 1 Capital or Total Capital, above the amount required to meet the PCR for Common Equity Tier 1 Capital, is not eligible to be included in the capital conservation buffer.
30. Capital distribution constraints will apply when an ADI's Common Equity Tier 1 Capital ratio falls within the capital buffer ranges outlined in Table 1 of Attachment B. Capital distribution constraints apply to distributions that affect Common Equity Tier 1 Capital. Items considered to be distributions for these purposes include:
- (a) dividends and share buybacks;⁴

⁴ This includes all distributions on mutual equity interests which must be treated as dividends for the purposes of this Prudential Standard, as required by *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*.

- (b) discretionary payments on **Additional Tier 1 Capital** instruments;⁵ and
 - (c) discretionary bonus payments to staff.⁶
31. An ADI may apply to APRA to make payments in excess of the constraints imposed by the capital conservation buffer regime. APRA will only grant approval where it is satisfied that an ADI has established measures to raise capital equal to or greater than the amount above the constraint that it wishes to distribute.

Countercyclical capital buffer

32. An ADI must hold additional Common Equity Tier 1 Capital as a countercyclical capital buffer, to be calculated in accordance with Attachment C to this Prudential Standard (ADI-specific countercyclical capital buffer).
33. APRA will determine the countercyclical capital buffer for the Australian jurisdiction (Australian jurisdictional countercyclical capital buffer) at a level of between 0 and 2.5 per cent of total risk-weighted assets.
34. APRA will publish any decision to set, or increase, the level of the Australian jurisdictional countercyclical capital buffer up to 12 months before the date from which it applies. Any decision by APRA to reduce the level of the Australian jurisdictional countercyclical capital buffer will take effect immediately.
35. The ADI-specific countercyclical capital buffer is to be applied by extending the range of the capital conservation buffer. Capital distribution constraints, as set out in Attachment B to this Prudential Standard, will apply if an ADI's Common Equity Tier 1 Capital ratio falls within the extended capital buffer range (consisting of the capital conservation buffer plus the ADI-specific countercyclical capital buffer).

Minimum leverage ratio requirement

36. Paragraphs 37 to 40 and Attachment D to this Prudential Standard, do not apply to [simple ADIs].
37. An ADI must calculate its leverage ratio in accordance with Attachment D to this Prudential Standard. Where an ADI:
- (a) is a member of a Level 2 group, the minimum leverage ratio requirement will apply only at Level 2; and
 - (b) is not a member of a Level 2 group, the minimum leverage ratio requirement will apply at Level 1.
38. An IRB ADI must, at all times, maintain a minimum leverage ratio of 3.5 per cent.

⁵ All payments of dividends or interest on eligible Additional Tier 1 capital instruments are, by definition, required to be discretionary.

⁶ This would include any remuneration payments that are made upon the exercise of a discretionary judgement of the Board or senior management of an ADI as to the amount or timing of payment.

39. A standardised ADI must, at all times, maintain a minimum leverage ratio of 3.0 per cent.
40. APRA may require an ADI to maintain a higher minimum leverage ratio.

Reductions in capital

41. An ADI or authorised NOHC (as applicable) must obtain APRA's written approval prior to making any planned reduction in capital, whether at Level 1 or Level 2.
42. A planned reduction in an ADI's capital includes:
 - (a) a share buyback or the redemption, repurchase or repayment of any qualifying Common Equity Tier 1 Capital, Additional Tier 1 Capital and **Tier 2 Capital** instruments issued by the ADI (or by other entities included in the calculation of the ADI's Level 2 capital);⁷
 - (b) trading in the ADI's own shares or capital instruments outside of any arrangement agreed with APRA in accordance with Prudential Standard *APS 111 Capital Adequacy: Measurement of Capital* (APS 111); and
 - (c) the aggregate amount of dividend payments on ordinary shares that exceeds an ADI's after-tax earnings after taking into account any payments on more senior capital instruments, in the financial year⁸ to which they relate.⁹
43. An ADI or authorised NOHC (as applicable) proposing a capital reduction (whether at Level 1 or Level 2) must provide APRA with a forecast showing, at the respective Levels, the projected future capital position after the proposed capital reductions. The forecast should extend for at least two years.
44. An ADI must satisfy APRA that the ADI's capital, at Level 1 and Level 2 as appropriate, will remain adequate for its future needs after a proposed reduction.

Notification requirements

45. An ADI or an authorised NOHC (as applicable) must notify APRA, in accordance with section 62A of the Banking Act, of any breach or prospective breach of the capital requirements contained in this Prudential Standard and inform APRA of any remedial actions taken or planned to deal with the breach.
46. An ADI or an authorised NOHC (as applicable) must inform APRA as soon as practicable of any:

⁷ For the avoidance of doubt, this does not include the repayment of a Tier 2 Capital instrument upon its contractual maturity date.

⁸ 'Financial year' means a period of 12 consecutive months covered by one or more sets of publicly available operating results preceding the date of the proposed payment of dividend or interest. For example, where an ADI makes available half-yearly operating results, a financial year will refer to the preceding two publicly available half-yearly operating results for the ADI.

⁹ This includes distributions on mutual equity interests which are also subject to the limits set out in Attachment K to APS 111.

- (a) significant departure from its ICAAP;
- (b) concerns it has about its capital adequacy (including projected losses), whether at Level 1 or Level 2, and the measures it proposes to take to address these concerns;
- (c) indication of significant adverse changes in market pricing of, or trading in, the capital instruments of the ADI or group of which it is a member (including pressures on the ADI to purchase its own capital instruments); and
- (d) other significant adverse changes in its capital, whether at Level 1 or Level 2.

Attachment A – Risk-based regulatory capital ratios

1. An ADI's Tier 1 Capital is the sum of its Common Equity Tier 1 Capital and Additional Tier 1 Capital. Its Total Capital is the sum of Tier 1 Capital and Tier 2 Capital. The criteria for inclusion in Common Equity Tier 1 Capital, Additional Tier 1 Capital and Tier 2 Capital are set out in APS 111.
2. Under APRA's risk-based capital adequacy framework, an ADI's capital adequacy is measured by means of risk-based capital ratios calculated by dividing each of its Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital by its total risk-weighted assets. That is:

$$\text{Common Equity Tier 1 Capital ratio} = \frac{\text{Common Equity Tier 1 Capital}}{\text{Total risk-weighted assets}}$$

$$\text{Tier 1 Capital ratio} = \frac{\text{Tier 1 Capital}}{\text{Total risk-weighted assets}}$$

$$\text{Total Capital ratio} = \frac{\text{Total Capital}}{\text{Total risk-weighted assets}}$$

where total risk-weighted assets are calculated as the sum of:

- (a) risk-weighted on-balance sheet and off-balance sheet assets determined in accordance with *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112);
- (b) risk-weighted on-balance sheet and off-balance sheet assets determined in accordance with *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113);
- (c) risk-weighted on-balance sheet and off-balance sheet assets determined in accordance with *Prudential Standard APS 120 Securitisation* (APS 120); and
- (d) 12.5 times the sum of the capital charges determined under *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk*, *Prudential Standard APS 115: Advanced Measurement Approaches to Operational Risk*, *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116), *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (Advanced ADIs) and *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180),

to the extent that each of these Prudential Standards applies to the ADI.

Attachment B – Constraints on capital distributions

- Capital distribution constraints apply when an ADI's Common Equity Tier 1 Capital ratio is within the capital buffer (CB) range (consisting of the capital conservation buffer plus any countercyclical capital buffer). The CB range is divided into four quartiles for the purposes of determining the minimum capital conservation ratios, as set out in Table 1.

Table 1: Minimum capital conservation standards

Minimum capital conservation standards	
Common Equity Tier 1 Capital ratio	Minimum capital conservation ratios (expressed as a percentage of earnings)
Within first quartile of buffer PCR to \leq (PCR + 0.25CB)	100
Within second quartile of buffer > (PCR + 0.25CB) to \leq (PCR + 0.50CB)	80
Within third quartile of buffer > (PCR + 0.50CB) to \leq (PCR + 0.75CB)	60
Within fourth quartile of buffer > (PCR + 0.75CB) to \leq (PCR + CB)	40
Above top of buffer > (PCR + CB)	0

- The minimum capital conservation ratios in Table 1 represent the percentage of earnings that an ADI must not distribute if its Common Equity Tier 1 Capital ratio falls within the corresponding quartile. If the Common Equity Tier 1 Capital ratio falls within the first quartile, the ADI must also cease all Tier 1 Capital distributions.
- Earnings are defined for the purposes of this Attachment as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after the tax that would have been reported had none of the distributable items been paid. As such, any tax impact of making such distributions is reversed out. An ADI that does not have positive earnings and has a Common Equity Tier 1 Capital ratio less than the sum of its Common Equity Tier 1 PCR plus the capital conservation buffer must not make positive net distributions.

4. Payments made by an ADI that do not result in a depletion of Common Equity Tier 1 Capital are not considered to be distributions for the purposes of this Attachment. APRA may impose restrictions on capital distributions even where an ADI's Common Equity Tier 1 Capital ratio is above the capital conservation buffer.
5. APRA may impose limits on the period in which an ADI may operate within the capital conservation buffer range, on a case-by-case basis.

Attachment C – Countercyclical capital buffer

1. An ADI must calculate the ADI-specific countercyclical capital buffer requirement as the weighted average of the jurisdictional countercyclical capital buffers that are applied by the regulatory authorities in jurisdictions in which the ADI has exposures.
2. The weighting applied to the jurisdictional countercyclical capital buffer in each jurisdiction will be the risk-weighted amount of an ADI's private sector credit exposures in that jurisdiction, divided by the risk-weighted amount of the ADI's private sector credit exposures across all jurisdictions, where:
 - (a) private sector credit exposures are:
 - (i) on-balance sheet assets, off-balance sheet exposures and on- and off-balance sheet securitisation and resecuritisation exposures determined under APS 112, APS 113 or APS 120, as relevant; and
 - (ii) exposures for which an ADI calculates a trading book capital charge for specific risk including equity specific risk, interest rate specific risk, incremental risk, securitisation and resecuritisation under APS 116,
 - (b) to private sector counterparties, excluding ADIs (and equivalent overseas deposit-taking institutions) but including other financial institutions; and
 - (c) the risk-weighted amount of an ADI's private sector credit exposures is the sum of:
 - (i) the risk-weighted assets for the assets and exposures in 2(a)(i); and
 - (ii) the risk-weighted equivalent trading book capital charges for exposures in 2(a)(ii).
3. When determining the jurisdiction to which a private sector credit exposure relates, ADIs must use an ultimate risk basis, where possible. An ADI must use the jurisdiction where the guarantor of the exposure resides, not where the exposure has been booked.
4. APRA may require an ADI to apply a higher countercyclical capital buffer for a particular jurisdiction than may be imposed by the host authority in that jurisdiction.
5. For Level 2 purposes, the ADI-specific countercyclical capital buffer must cover all exposures incurred in relevant jurisdictions, even though the business may be undertaken by a member of the Level 2 group that is not itself an ADI or equivalent overseas deposit-taking institution.
6. For the Value-at-Risk (VaR) for specific risk, the incremental risk charge and the comprehensive risk measurement charge included in calculating the ADI-specific countercyclical capital buffer, an ADI must consult with APRA to develop an

approach that would translate these charges into individual instrument risk-weights that would then be allocated to the geographic location of the specific counterparties that make up the charge.

Attachment D – Leverage ratio

This Attachment does not apply to [simple ADIs].

1. An ADI must calculate its leverage ratio as follows:

$$\text{Leverage ratio} = \frac{\textit{Tier 1 Capital}}{\textit{Exposure Measure}}$$

where:

- (a) Tier 1 Capital is determined in accordance with APS 111; and
- (b) the exposure measure is determined in accordance with this Attachment and is calculated as the sum of:
 - (i) on-balance sheet exposures;
 - (ii) non-market related off-balance sheet exposures;
 - (iii) derivative exposures; and
 - (iv) securities financing transaction (SFT) exposures.
2. Unless otherwise specified in this Attachment, an ADI must follow **Australian Accounting Standards** in calculating its exposure measure, subject to the following:
 - (a) physical or financial collateral, guarantees or other credit risk mitigation techniques must not be taken into account by an ADI to reduce the exposure measure;
 - (b) netting of assets and liabilities is not permitted; and
 - (c) securitisation exposures which meet the operational requirements for regulatory capital relief, as set out in APS 120, may be excluded from the exposure measure. All other securitisation exposures, including funding-only and synthetic securitisations, must be included in the exposure measure.
3. APRA may temporarily exclude central bank reserves from the leverage ratio exposure measure in exceptional macroeconomic circumstances. If APRA excludes central bank reserves, it may increase the minimum leverage ratio requirement commensurately to offset the impact of the exclusion. In the event that APRA excludes central bank reserves from the calculation of the exposure measure, an ADI must disclose the impact of the exclusion, as well as its leverage ratio calculated without the benefit of the exclusion.

Standardised ADIs

4. A standardised ADI must calculate its leverage ratio exposure measure in accordance with paragraphs 5 to 13 of this Attachment.

On-balance sheet exposures

5. In determining its on-balance sheet exposures, an ADI must include all balance sheet assets, including any on-balance sheet collateral for derivatives and SFTs.
6. Balance sheet assets deducted from Common Equity Tier 1 Capital and Additional Tier 1 Capital for the purposes of regulatory adjustments under APS 111 may be deducted from the exposure measure.
7. Liability items must not be deducted from the exposure measure, including any gains and losses on fair value liabilities, or accounting value adjustments on derivative liabilities due to changes in an ADI's own credit risk.
8. On-balance sheet assets may be included in the exposure measure at their accounting values net of:
 - (a) associated specific provisions; and
 - (b) general provisions or general reserves for credit losses held against future, presently unidentified losses, which are freely available to meet losses, where these provisions or reserves have reduced or otherwise been deducted from Tier 1 Capital.
9. Where an ADI holds assets in a fiduciary capacity, these assets may be excluded from the exposure measure provided that the assets meet the accounting criteria for derecognition and, where applicable, the accounting criteria for deconsolidation.

Non-market-related off-balance sheet exposures

10. To determine non-market-related off-balance sheet exposures for the purposes of the leverage ratio, an ADI must apply credit conversion factors (CCFs) to the gross notional amounts of off-balance sheet items. An ADI must apply the CCFs set out in Table 1 of Attachment B to APS 112.
11. For any off-balance sheet securitisation exposures, an ADI must apply the relevant CCFs as set out in paragraph 43 of APS 120.
12. Specific and general provisions that have decreased Tier 1 Capital may be deducted from the credit exposure equivalent amount (i.e. the exposure amount after the application of the relevant CCF). However, the resulting off-balance sheet equivalent amount for these exposures cannot be less than zero.

Derivative and securities financing transaction exposures

13. An ADI must calculate its derivative and SFT exposures in accordance with Australian Accounting Standards, subject to paragraph 2 of this Attachment.

IRB ADIs*On-balance sheet exposures*

14. An IRB ADI must calculate its on-balance sheet exposures in accordance with paragraphs 5 to 9 and 15 to 17 of this Attachment.

Unsettled trades

15. An IRB ADI must account for regular-way purchases or sales of financial assets that have not been settled on the following basis:
- (a) ADIs which apply trade date accounting must reverse out any offsetting between cash receivables for unsettled sales and cash payables for unsettled purchases of financial assets. Thereafter, ADIs may offset between those cash receivables and cash payables (irrespective of whether such offsetting is permitted under Australian Accounting Standards) only if all of the following conditions are met:
 - (i) the financial assets bought and sold that are associated with cash payables and receivables are measured at fair value through the income statement and included in the ADI's trading book in accordance with Attachment A to APS 116; and
 - (ii) the transactions of the financial assets are settled on a delivery-versus-payment basis;
 - (b) ADIs which apply settlement date accounting must apply the treatment set out in paragraphs 18 and 19 of this Attachment.

Cash pooling

16. If an IRB ADI uses cash pooling arrangements which combine the credit and debit balances of several individual participating customer accounts into a single account balance, the IRB ADI may recognise the single account balance in its calculation of the exposure measure if:
- (a) the balances are transferred on at least a daily basis; and
 - (b) the IRB ADI cannot be held liable for the balances on an individual basis upon the transfer, i.e. the IRB ADI can only be held liable for a single claim based on the single account.
17. If cash pooling arrangements do not meet the conditions set out in paragraph 16 of this Attachment, the individual balances of the participating customer accounts must be reflected separately in the exposure measure.

Non-market-related off-balance sheet exposures

18. An IRB ADI must determine its non-market-related off-balance sheet exposures in accordance with paragraphs 10 to 12 and, if relevant, paragraph 19 of this Attachment.

19. If the exposure amount relates to an unsettled regular-way financial asset purchase (i.e. the commitment to pay) that is accounted for at settlement date, an ADI must apply a CCF of 100 per cent. An ADI may offset commitments to pay for unsettled purchases and cash to be received for unsettled sales provided the following conditions are met:
- (a) the financial assets bought and sold that are associated with the cash payables and receivables are included in the ADI's income statement at fair value and allocated to the ADI's trading book in accordance with Attachment A to APS 116; and
 - (b) the transactions of the financial assets are settled on a delivery-versus-payment basis.

Derivative exposures

20. For the purpose of calculating the exposure measure, an IRB ADI must apply the specific treatment set out in paragraphs 21 to 42 of this Attachment to any derivatives exposures.

Treatment of derivatives

21. An IRB ADI must calculate its exposures associated with all derivative transactions, including where it sells protection using a credit derivative, as:

$$\text{exposure measure} = 1.4 * (RC + PFE)$$

where:

RC = the replacement cost, calculated according to paragraph 25 of this Attachment; and

PFE = the potential future exposure, calculated according to paragraphs 26 and 27 of this Attachment.

22. An IRB ADI must calculate its exposure to a single derivatives transaction not covered by an eligible bilateral netting agreement by applying the formula in paragraph 21 of this Attachment to each transaction separately.
23. An IRB ADI must calculate its exposure to derivatives transactions covered by an eligible bilateral netting agreement by applying the formula in paragraph 21 of this Attachment at the netting set level.¹²
24. For the purposes of calculating the leverage ratio exposure measure, an eligible bilateral netting agreement is one that meets the criteria in Attachment I to APS 112.¹³

¹² Netting set is defined in paragraph 8(s) of APS 180.

¹³ For the purpose of calculating the leverage ratio exposure measure, cross-product netting (i.e. between derivatives and SFTs) is not permitted.

Calculation of the replacement cost

25. The RC of a transaction or netting set is measured as follows:

$$RC = \max \{V - CVM_r + CVM_p, 0\}$$

where:

V = the market value of the individual derivative transaction, or of the derivative transactions in a netting set;

CVM_r = the cash variation margin *received* that meets the conditions set out in paragraph 30 of this Attachment and for which the amount has not already reduced the market value of the derivative transaction V under Australian Accounting Standards; and

CVM_p = the cash variation margin provided by the ADI that meets the conditions set out in paragraph 30 of this Attachment and for which the amount has not already increased the market value of the derivative transaction V under Australian Accounting Standards.

Calculation of the potential future exposure

26. The PFE for derivative exposures must be calculated in accordance with Attachment D to APS 180. Specifically,

$$PFE = m * AddOn_{aggregate}$$

where:

$m = 1$; and

$AddOn_{aggregate}$ = the aggregation of all add-on components calculated in accordance with Attachment D to APS 180. The maturity factor used must reflect the treatment for margined and unmargined transactions.

27. Written options must be included in the leverage ratio exposure measure, even where the exposure at default may be set to zero under APS 180.

Treatment of related collateral

28. An IRB ADI must not reduce its exposure measure by the amount of any derivatives collateral *received* from a counterparty.
29. An IRB ADI must increase its exposure measure by the amount of any derivatives collateral *provided* by it to a counterparty, where the provision of that collateral has reduced the value of its balance sheet assets under Australian Accounting Standards.

Treatment of cash variation margin

30. An IRB ADI may reduce its exposure measure by treating the cash portion of variation margin exchanged between counterparties as a form of pre-settlement payment, if the following conditions are met:
- (a) for trades not cleared through a qualifying central counterparty (QCCP),¹⁴ the cash received by the recipient counterparty must not be segregated. Cash variation margin would satisfy the non-segregation criteria if the recipient counterparty is not subject to any restrictions by law, regulation or agreement on the counterparty's ability to use the cash received;
 - (b) variation margin is calculated and exchanged on a daily basis based on mark-to-market valuation of derivatives positions. In order to meet this requirement, derivative positions must be valued daily and cash variation margin must be transferred at least daily to the counterparty;
 - (c) the cash variation margin is received in a currency specified in the derivatives contract, governing master netting agreement (MNA),¹⁵ credit support annex to the qualifying MNA or as defined by any netting agreement with a central counterparty (CCP);¹⁶
 - (d) variation margin exchanged is the full amount that would be necessary to extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty;¹⁷ and
 - (e) derivatives transactions and variation margins are covered by a single MNA between the legal entities that are the counterparties in the derivatives transaction. The MNA must explicitly stipulate that the counterparties agree to settle on a net basis any payment obligations covered by the MNA, taking into account any variation margin received or provided if a credit event occurs involving either counterparty.
31. If the conditions in paragraph 30 of this Attachment are met and an IRB ADI:
- (a) *receives* cash variation margin from a counterparty, it may reduce the RC (but not the PFE component) of the exposure amount of the derivative asset consistent with paragraph 25 of this Attachment; and
 - (b) *provides* cash variation margin to a counterparty, it may deduct the resulting receivable from its exposure measure, where the cash variation margin has been recognised as an asset in accordance with Australian Accounting

¹⁴ QCCP is defined in paragraph 11(u) of APS 112.

¹⁵ MNA includes any netting agreement that provides legally enforceable rights of offset and also satisfies the criteria for bilateral netting agreements as set out in paragraphs 7 to 17 of Attachment I to APS 112. A master MNA, which is an overarching agreement that provides a legally enforceable right to net across more than one MNA, may be deemed to be a single MNA.

¹⁶ CCP is defined in paragraph 11(a) of APS 112.

¹⁷ In situations where a margin dispute arises, the amount of non-disputed variation margin that has been exchanged can be recognised.

Standards, and instead include the cash variation margin provided in the calculation of the RC consistent with paragraph 25 of this Attachment.

Treatment of clearing services

32. When an IRB ADI acting as a clearing member (CM)²¹ offers clearing services to clients, its trade exposures to the CCP must be included in its exposure measure by applying the same treatment as for any other type of derivative transaction.²⁴ Trade exposures to a CCP arise when the ADI is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults.
33. When an IRB ADI acting as a CM is not contractually obligated to reimburse the client for any losses suffered in the event that a QCCP defaults, the ADI may exclude the resulting trade exposures to the QCCP from its exposure measure.
34. When a client enters directly into a derivative transaction with a CCP, and an IRB ADI acting as a CM guarantees the performance of the client's transaction to the CCP, the ADI must calculate its related leverage ratio exposure resulting from the guarantee as a derivative exposure in accordance with paragraphs 21 to 31 of this Attachment, as if it had entered directly into the transaction with the client.
35. If an entity falls within the Level 2 group of the IRB ADI acting as a CM, trades between that entity and the ADI are eliminated in the course of consolidation and the ADI retains an exposure to the CCP. In this case, the transaction with the CCP will be considered proprietary for the IRB ADI acting as a CM, and the exemption set out in paragraph 33 of this Attachment will not apply.

Additional treatment for written credit derivatives

36. For written credit derivatives, an IRB ADI must apply the additional treatment set out in paragraphs 36 to 42 of this Attachment. For the purposes of this Attachment, written credit derivative refers to a broad range of credit derivatives through which a bank effectively provides credit protection and is not limited solely to credit default swaps and total return swaps.
37. To capture the credit exposure to the underlying reference entity, the effective notional amount²⁵ referenced by a written credit derivative must be included in the exposure measure unless:
 - (a) the written credit derivative is included in a transaction cleared on behalf of a client of the ADI acting as a CM; and
 - (b) the transaction meets the requirements of paragraph 33 of this Attachment for the exclusion of trade exposures to the QCCP.

²¹ Clearing member is defined in paragraph 11(b) of APS 112.

²⁴ For the purposes of paragraphs 32 to 35 of this Attachment, trade exposures includes initial margin irrespective of whether or not it is posted in a manner that makes it remote from the insolvency of the CCP.

²⁵ The effective notional amount is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.

38. The effective notional amount of a written credit derivative may be reduced in one or both of the following ways:
- (a) by any negative change in the fair value amount that has been incorporated into the calculation of Tier 1 Capital with respect to the written credit derivatives; and
 - (b) by the effective notional amount of an offsetting purchased credit derivative on the same reference name²⁶ provided the conditions set out in paragraph 39 of this Attachment are satisfied.
39. An IRB ADI may reduce the effective notional amount through the application of offsetting purchased credit derivatives if the following conditions are satisfied:
- (a) the credit protection purchased through credit derivatives is otherwise subject to the same, or more conservative, material terms as those in the corresponding written credit derivative.²⁹ This ensures that if an ADI provides written credit protection via a credit derivative, it may only recognise offsetting from another purchased credit derivative if the purchased protection is certain to deliver a payment to the ADI in all potential future outcomes;
 - (b) the remaining maturity of the credit protection purchased through credit derivatives is equal to or greater than the remaining maturity of the written credit derivatives;
 - (c) the credit protection purchased through credit derivatives is not purchased from a counterparty whose credit quality is highly correlated with the value of the reference obligation;
 - (d) in the event that the effective notional amount of a written credit derivative is reduced by any negative change in fair value reflected in the ADI's Tier 1 Capital, the effective notional amount of offsetting credit protection purchased through credit derivatives must also be reduced by any resulting positive change in fair value reflected in Tier 1 Capital; and
 - (e) the credit protection purchased through credit derivatives is not included in a transaction that has been cleared on behalf of a client and for which the effective notional amount referenced by the corresponding written credit derivative is excluded from the exposure measure under paragraph 33 of this Attachment.
40. Credit protection purchased on a pool of reference names may only offset credit protection sold on individual reference names if the credit protection purchased is economically equivalent to buying protection separately on each of the individual names in the pool. If the credit protection purchased does not cover the entire pool (i.e. the protection covers only a subset of the pool, as in the case of

²⁶ Two reference names are considered identical only if they refer to the same legal entity.

²⁹ Material terms include the level of subordination/seniority, optionality, strike price, credit events, reference name and any other characteristics relevant to the valuation of the derivative.

an nth-to-default credit derivative or a securitisation tranche), no offsetting of credit protection sold on individual reference names is allowed.

41. Where an IRB ADI purchases credit protection through a total return swap and records the net payments received as net income, but does not record the offsetting deterioration in the value of the written credit derivative (either through reductions in fair value or by an addition to reserves) in Tier 1 Capital, the credit protection must not be used to offset the effective notional amounts of the written credit derivatives.
42. An IRB ADI may choose to exclude from the netting set for the calculation of PFE the portion of a written credit derivative which is not offset according to paragraph 38 of this Attachment, and for which the effective notional amount is included in the exposure measure.

Securities financing transaction exposures

43. For the purpose of calculating the exposure measure, an IRB ADI must apply the specific treatment set out in paragraphs 44 to 52 of this Attachment to any SFT exposures.³³

ADI acting as a principal

44. When an IRB ADI is acting as a principal in a SFT, its exposure measure must include the sum of the following amounts:
 - (a) gross SFT assets recognised for accounting purposes³⁴ (i.e. with no recognition of accounting netting), adjusted as follows:
 - (i) excluding the value of any securities received under an SFT, where the ADI has recognised the securities as an asset on its balance sheet; and
 - (ii) cash payables and cash receivables in SFTs with the same counterparty may be measured net if all the following criteria are met:
 - (A) transactions have the same explicit final settlement date. Transactions with no explicit end date but which can be unwound at any time by either party to the transaction are not eligible;
 - (B) the right to set-off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both in

³³ SFT is defined in paragraph 11(y) of APS 112.

³⁴ For SFT assets subject to novation and cleared through QCCPs, 'gross SFT assets recognised for accounting purposes' are replaced by the final contractual exposure, given that pre-existing contracts have been replaced by new legal obligations through the novation process. However, ADIs may only net cash receivables and cash payables with a QCCP if the criteria in paragraph 44(a)(ii) are met. Any other netting permitted by the QCCP is not permitted for the purposes of the leverage ratio.

the normal course of business and in the event of the default, insolvency or bankruptcy of the counterparty; and

- (C) the counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement;³⁶ If there is a failure of the securities leg of a transaction at the end of the window for settlement in the settlement mechanism, then this transaction and its matching cash leg must be split out from the netting set and treated gross; and
- (b) a measure of CCR calculated as the current exposure without a PFE add-on, calculated as follows:

- (i) where a qualifying MNA as defined in paragraphs 46 and 47 of this Attachment is in place, the current exposure (E^*) must be set to the greater of zero and the total fair value of securities and cash lent to a counterparty for all transactions included in the qualifying MNA ($\sum E_i$) less the total fair value of cash and securities received from the counterparty for those transactions ($\sum C_i$). This is illustrated in the following formula:

$$E^* = \max \{0, [\sum E_i - \sum C_i]\}$$

- (ii) where no qualifying MNA is in place, the current exposure for transactions with a counterparty must be calculated on a transaction by transaction basis; that is, each transaction i is treated as its own netting set, as shown in the following formula:

$$E_i^* = \max \{0, [E_i - C_i]\}$$

E_i^* may be set to zero if:

- (A) E_i is the cash lent to a counterparty;
- (B) this transaction is treated as its own netting set; and
- (C) the associated cash receivable is not eligible for the netting treatment in paragraph 44(a) of this Attachment.

45. For the purposes of paragraph 44(b) of this Attachment, the term counterparty includes not only the counterparty of the bilateral repurchase transactions, but also triparty repurchase agents that receive collateral in deposit and manage the collateral in the case of triparty repurchase transactions. Securities deposited at triparty repurchase agents are included in the total value of securities and cash

³⁶ To achieve such equivalence, both transactions are settled through the same settlement system and the settlement arrangements are supported by cash or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and, any issues arising from the securities legs of the SFTs do not interfere with the completion of the net settlement of the cash receivables and payables. The failure of any single securities transaction in the settlement mechanism may delay settlement of only the matching cash leg or create an obligation to the settlement mechanism, supported by an associated credit facility.

lent to a counterparty (E) up to the amount effectively lent to the counterparty in a repurchase transaction. However, excess collateral that has been deposited at triparty agents but that has not been lent out may be excluded.

46. For the purpose of paragraph 44(b), a bilateral netting agreement for covering SFTs may be recognised as a qualifying MNA on a counterparty by counterparty basis only if it:
 - (a) is legally enforceable in each relevant jurisdiction upon the occurrence of an event of default, regardless of whether the counterparty is insolvent or bankrupt;
 - (b) provides the non-defaulting party with the right to terminate and close out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;
 - (c) provides for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other; and
 - (d) allows for the prompt liquidation or set-off of collateral in the event of default.
47. Netting across SFT positions held in the banking book and trading book will only be recognised when the netted transactions meet the conditions set out in paragraph 5 of Attachment I to APS 112.
48. Where an IRB ADI applies sale accounting to an SFT in accordance with Australian Accounting Standards, it must reverse all sales-related accounting entries, and then calculate its exposure as if the SFT had been treated as a financing transaction under those standards (i.e. the ADI must include the sum of amounts in paragraphs 44(a) and 44(b) of this Attachment for such an SFT) for the purposes of determining its exposure measure.

ADI acting as an agent

49. If an IRB ADI acting as an agent in an SFT provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash that the customer has lent and the value of collateral that the borrower has provided, the ADI must calculate its exposure measure by applying only paragraph 44(b) of this Attachment.
50. An IRB ADI is eligible to apply the treatment set out in paragraph 49 of this Attachment only if the ADI's exposure to the transaction is limited to the guaranteed difference between the value of the security or cash its customer has lent, and the value of the collateral the borrower has provided. Where the ADI is further economically exposed (i.e. beyond the guarantee for the difference) to the underlying security or cash in the transaction, a further exposure equal to the full amount of the security or cash must be included in the exposure measure.

51. Where an IRB ADI acting as an agent provides an indemnity or guarantee to both parties involved in an SFT (i.e. securities lender and securities borrower), the ADI must calculate its exposure measure separately for each party involved in the transaction.
52. When an IRB ADI acting as agent in an SFT does not provide an indemnity or guarantee to any of the involved parties, the IRB ADI has no exposure to the SFT, and is not required to include those SFTs in its exposure measure.