



Prudential Practice Guide

APG 110 – Capital Buffers

August 2016

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About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

This PPG provides guidance on the capital buffer that an authorised deposit-taking institution (ADI) must hold above its prudential capital requirement in accordance with *Prudential Standard APS 110 Capital Adequacy*. The capital buffer includes the capital conservation buffer, countercyclical capital buffer and the surcharge for domestic systemically important banks, as applicable. In particular, this PPG provides guidance to an ADI on:

- calculating its countercyclical capital buffer; and
- the operation of the constraints on distributions that apply when its Common Equity Tier 1 capital ratio is within the capital buffer range.

This PPG should be read in conjunction with the following prudential standards, reporting standard and PPGs:

- *Prudential Standard APS 110 Capital Adequacy*;
- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*;
- *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*;
- *Prudential Standard APS 116 Market Risk*;
- *Prudential Standard APS 120 Securitisation*;
- *Prudential Standard APS 330 Public Disclosure*;

- *Prudential Practice Guide APG 112 Standardised Approach to Credit Risk*;
- *Prudential Practice Guide APG 113 Internal Ratings-based Approach to Credit Risk*;
- *Prudential Practice Guide APG 116 Market Risk*;
- *Prudential Practice Guide APG 120 Securitisation*;
- *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review*; and
- *Reporting Standard ARS 231 International Exposures*.

Not all of the practices outlined in this PPG will be relevant for every ADI and some aspects may vary depending upon the size and complexity of the institution.

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Introduction – The capital buffer framework

1. In 2010, the Basel Committee on Banking Supervision (Basel Committee) released a package of reforms to promote a more resilient global banking system (Basel III)¹. The Basel III capital reforms introduced, in addition to strengthened requirements in relation to the minimum quantity and quality of capital that ADIs must hold, a requirement for ADIs to maintain an additional buffer of capital above minimum levels.
2. This buffer is intended to promote the conservation of capital and the build-up of adequate buffers above minimum requirements that can be used to absorb losses during periods of financial and economic stress. Although an ADI may utilise this buffer to absorb losses in times of stress without being regarded as being in breach of minimum regulatory requirements, utilisation of the buffer will lead to the ADI being increasingly limited in its capacity to make certain types of distributions, i.e. payments to the holders of certain capital instruments and discretionary bonus payments to staff.
3. The size of the buffer that an individual ADI is required to hold to avoid constraints on its distributions comprises:
 - a) a capital conservation buffer of 2.5 per cent of risk-weighted assets (RWA)², which must be held in the form of Common Equity Tier 1 (CET1) capital. For ADIs designated by APRA as domestic systemically important banks (D-SIBs), this buffer is set at a higher level; currently, D-SIBs need to maintain a capital conservation buffer of 3.5 per cent³; and
 - b) a countercyclical capital buffer, which will range between 0 and 2.5 per cent of RWA. This buffer must also be in the form of CET1 capital.
4. The requirement for a capital conservation buffer applies to an ADI at all times. The countercyclical capital buffer also applies to all locally incorporated ADIs⁴ but will vary over time based on jurisdictional countercyclical capital buffers determined by national authorities in relevant jurisdictions, taking account of credit market conditions. The countercyclical capital buffer is designed to ensure that ADIs build up capital buffers when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk. This additional buffer can then be released during periods of stress, to reduce the risk of the supply of credit being impacted by regulatory capital requirements⁵.
5. The capital buffer regime imposes constraints on an ADI when its CET1 capital ratio falls within the capital conservation buffer range. The extent of constraint increases the closer an ADI's CET1 capital ratio is to the required minimum. The distribution constraints, based on a 2.5 per cent capital conservation buffer, are shown in the table below. An ADI would be required to conserve 80 per cent of its earnings if its CET1 capital ratio was between 0.625 per cent and 1.25 per cent above its minimum CET1 capital requirement. That is, it could not make distributions that represented more than 20 per cent of its earnings in terms of dividends, share buybacks, discretionary payments on Additional Tier 1 capital

1 Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011*: www.bis.org/publ/bcbs189.htm

2 APRA may determine a capital conservation buffer other than 2.5 per cent for an ADI; however, the sum of an ADI's CET1 prudential capital requirement (PCR) plus the capital conservation buffer determined by APRA will be no less than 7.0 per cent of the ADI's RWA.

3 Refer to APRA's Information Paper, *Domestic systemically important banks in Australia*:

<http://www.apra.gov.au/adi/Publications/Documents/Information-Paper-Domestic-systemically-important-banks-in-Australia-December-2013.pdf>.

4 Other than providers of purchased payment facilities

5 See *Guidance for national authorities operating the countercyclical capital buffer*, Basel Committee on Banking Supervision, December 2010:

<http://www.bis.org/publ/bcbs187.htm>

instruments and discretionary bonus payments to staff.

Capital buffer thresholds	Constraint on distributions: % of profits that must be retained
>2.5%	0
>1.875 to 2.5%	40
>1.25 to 1.875%	60
>0.625 to 1.25%	80
Up to 0.625%	100

6. The countercyclical capital buffer is applied by scaling up the capital conservation buffer. For example, assuming an ADI has a 2.5 per cent countercyclical capital buffer, the thresholds in the table above would be doubled.

Part A – Countercyclical capital buffer

Elements of the countercyclical capital buffer

7. The countercyclical capital buffer framework consists of two elements:
 - a) the ‘jurisdictional buffer’, which is set by a national authority and is the percentage of RWA that a national authority may apply to banking institutions operating in its jurisdiction as a jurisdictional countercyclical capital buffer⁶; and
 - b) the ‘ADI-specific buffer’, which is calculated by an ADI and is the weighted average of the jurisdictional buffers applying in each jurisdiction in which the ADI has private sector credit exposures. The ADI-specific buffer applies to an ADI’s total RWA and the buffer is held in the form of CET1 capital.
8. In this PPG, unless otherwise indicated references to ‘ADI’ are to the Level 1 ADI and the Level 2 group. Exposures of subsidiaries included at Level 1 in an Extended Licence Entity⁷ that meet the requirements of the buffer framework are intended to be included in the ADI-specific buffer calculation.

Determining the ADI-specific buffer

9. This PPG provides guidance on the steps involved in calculating the ADI-specific buffer, including identification of ‘private sector credit exposures’ and the jurisdictional weighting process.
10. An ADI that has private sector credit exposures solely in Australia would apply the jurisdictional buffer set by APRA to its total RWA without adjustment – the ADI-specific buffer is simply the Australian jurisdictional countercyclical capital buffer.

Jurisdictional reciprocity

11. Underpinning the countercyclical capital buffer framework is the principle that the application of the buffer in a given jurisdiction does not distort the level playing field between domestic banking institutions and foreign banking institutions with exposures to counterparties in the same jurisdiction. Through the weighting process, credit exposures to a private sector counterparty located in any given jurisdiction will attract the same buffer requirement, irrespective of the location of the banking institution providing credit. The ADI-specific buffer calculation gives effect to this principle.
12. *Prudential Standard APS 110 Capital Adequacy (APS 110)* requires an ADI to include private sector credit exposures in all jurisdictions when calculating its ADI-specific buffer, including jurisdictions that are not members of the Basel Committee such as New Zealand. APRA expects that an ADI will have robust systems and processes in place to measure exposures in all jurisdictions.
13. The Basel Committee maintains a list of the countercyclical capital buffers in jurisdictions at <http://www.bis.org/bcbs/ccyb/index.htm>.
14. Although designed primarily to centralise the buffers in jurisdictions that are members of the Basel Committee, non-member jurisdictions may also submit details of their countercyclical capital buffers for inclusion on this website. APRA expects that a prudent ADI would also ensure that it has in place other measures to ensure that it is cognisant of all regulatory requirements in jurisdictions in which it operates.
15. For the purposes of the ADI-specific buffer, an ADI would apply the jurisdictional buffer in each jurisdiction in which it has private sector

⁶ APRA’s approach to, and announcements of, the Australian jurisdictional countercyclical capital buffer are set out at <http://apra.gov.au/adi/PrudentialFramework/Pages/capital-buffers.aspx>

⁷ Refer to *Prudential Standard APS 222 Associations with Related Entities*.

credit exposures, even if the jurisdictional buffer is higher than the minimum set out in the Basel Committee's framework. However, it is not mandatory for an ADI to apply a sectoral countercyclical capital buffer that only applies to a sub-set of RWA. For example, a buffer applying only to housing loans in a foreign jurisdiction would not need to be recognised directly by an Australian ADI. An overseas subsidiary bank of an Australian ADI would of course be subject to the regulatory requirements of that foreign jurisdiction, including any sectoral buffers.

Identifying the jurisdiction

16. As set out in APS 110, jurisdiction is determined on the basis of an exposure's 'ultimate risk', where possible. The jurisdiction of ultimate risk is contrasted to the jurisdiction of 'immediate risk'; both terms inform the Bank for International Settlements' (BIS) international consolidated banking statistics⁸.
17. *Reporting Standard ARS 231 International Exposures* incorporates these definitions and provides instructions to ADIs on identifying the jurisdiction of ultimate risk. These instructions are also relevant for calculating the ADI-specific buffer. Table 1 in Appendix A provides further examples of the difference between ultimate and immediate risk.
18. Although APRA expects that an ADI would make reasonable efforts to identify the jurisdiction of ultimate risk, APRA acknowledges that this may not always be readily possible. This may be, for instance, because capital requirements are determined on a portfolio basis according to the type of counterparty without reference to jurisdiction. APRA expects that an ADI would discuss with its responsible supervisor the intended approach to allocating exposures by jurisdiction in such circumstances.

Private sector credit exposures

19. Only private sector credit exposures are included in the calculation of the ADI-specific buffer. To identify the relevant exposures, an ADI needs to consider both the type of (private sector) counterparty and the value of the (credit) exposure.
20. As outlined below, both banking book and trading book private sector credit exposures are included and they are to be defined in terms of RWA, or risk-weighted equivalent amounts, for the purposes of calculating the ADI-specific buffer.
21. Under APS 110, an ADI is to use the methodology for determining RWA set out in APRA's capital adequacy prudential standards to determine the amount of its private sector credit exposures in a non-Australian jurisdiction. However, an overseas banking subsidiary of an Australian ADI operating in another jurisdiction would apply the methodology used in that jurisdiction when calculating its standalone buffer.

Definition of private sector

22. For the purposes of calculating the ADI-specific buffer, 'private sector' exposures exclude those to:
 - a) ADIs, equivalent overseas deposit-taking institutions and other banking entities such as international banking agencies and regional development banks; and
 - b) Australian Commonwealth, State, Territory and local governments, non-commercial public sector entities and overseas central, state, regional and local governments and non-commercial public sector entities.

Although exposures to banking institutions are excluded, exposures to other financial sector counterparties would be considered to be private sector exposures. Exposures to commercial public sector entities would also be considered to be private sector exposures.

⁸ The published statistics are available at: <http://www.bis.org/statistics/index.htm>

Exposures in the banking book

23. The relevant private sector credit exposures in the banking book are the RWA for credit risk relating to on- and off-balance sheet assets and exposures to private sector counterparties, including securitisation exposures⁹.

Exposures in the trading book

24. To calculate the private sector credit exposures in the trading book, an ADI needs to multiply the regulatory capital charges (see below) by 12.5 to determine the equivalent RWA.
25. For positions where the standardised approach for specific risk is used, the relevant private sector trading book regulatory capital charges comprise the on- and off- balance sheet:
- capital charges for equity specific risk;
 - capital charges for interest rate specific risk for non-securitisation exposures;
 - capital charges for securitisation correlation trading portfolios; and
 - any other applicable capital charges for securitisation exposures in the trading book.
26. For positions where an internal models approach for specific risk is used, as set out in APS 110, the relevant private sector trading book regulatory capital charges would be determined based on an approach proposed by the ADI that would need to be agreed with APRA.

Calculating the ADI-specific buffer

27. As the ADI-specific buffer is the weighted average of jurisdictional buffers, an ADI needs to calculate the relevant weight for each jurisdiction in which it has exposures.
28. Each jurisdictional weight is determined by dividing the total risk-weighted amounts for an ADI's private sector credit exposures in that

jurisdiction by the total risk-weighted amounts for private sector credit exposures across all jurisdictions.

29. The ADI-specific buffer (ADI CCyB) may be calculated as the sum of each jurisdictional weight (w_j) multiplied by the jurisdictional buffer (CCyB_j) in that jurisdiction:

$$\text{ADI CCyB} = \sum_{\text{all jurisdictions}} w_j \text{CCyB}_j$$

30. Appendix B sets out two approaches to calculating the ADI-specific buffer. Table 2 provides a worked example of the calculation for an ADI using the internal ratings-based approach to credit risk, while Table 3 provides a worked example for an ADI using the standardised approach to credit risk. These are illustrative only, and it is open to an ADI to use an alternative approach to meet the ADI-specific buffer requirements.

Applying the ADI-specific buffer

31. The ADI-specific buffer applies to total RWA. It is to be met with CET1 capital and it is an extension of the capital conservation buffer.

Frequency

32. APRA expects that an ADI would include calculation of its countercyclical capital buffer in its existing regulatory capital calculation processes, and incorporate the countercyclical capital buffer framework into its Internal Capital Adequacy Assessment Process.
33. A prudent ADI would recalculate its countercyclical capital buffer when there is a material change in its private sector credit exposures in a jurisdiction where a non-zero countercyclical capital buffer applies, or there is a change in a jurisdictional buffer in a jurisdiction in which it has private sector credit exposures.
34. Any recalculation would also be expected where an ADI's CET1 capital ratio falls into the capital buffer range (refer to Part B).

⁹ Refer to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk, Prudential Standard*

APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk and Prudential Standard APS 120 Securitisation.

Public disclosure

35. Under *Prudential Standard APS 330 Public Disclosure* (APS 330), an ADI must make certain disclosures (semi-annually or annually) related to its countercyclical capital buffer, including ‘the geographic breakdown of the private sector credit exposures, at country level’ on an unweighted basis. However, for consistency with other capital adequacy calculations and to facilitate an understanding of how its ADI-specific buffer is calculated, an ADI may choose to also disclose its private sector credit exposures on a risk-weighted basis.
36. A prudent ADI would ensure that its public disclosures provide sufficient information to give users an understanding of the inputs used to determine the ADI-specific buffer. To facilitate adequate understanding, it may not be necessary to list separately jurisdictions that have a zero or unannounced countercyclical capital buffer, for instance, if the ADI is of the view that such omissions are considered immaterial under paragraph 55 of APS 330. However, APRA expects that an ADI would disclose the total of exposures that are not subject to a positive countercyclical capital buffer to facilitate understanding of the basis for the ADI-specific buffer.

Part B – Operation of constraints on capital distributions

37. Under APS 110, an ADI is required to maintain a capital buffer comprising the countercyclical capital buffer and the capital conservation buffer (including a D-SIB surcharge as applicable) in addition to its PCR. If an ADI's CET1 capital ratio falls within the capital buffer range, constraints on capital distributions would apply. This part provides guidance on key matters pertaining to the operation of constraints on capital distributions.
38. APRA's expectation is that an ADI would not normally operate in the capital buffer range and that declaring a distribution that takes the ADI into the range would be an exception. If an ADI is within the capital buffer range, APRA would expect the ADI to take timely action to restore its capital position and move out of the capital buffer range as quickly as possible.

Triggering constraints

39. If an ADI is not operating within the capital buffer range, but announces a distribution that would take it into the capital buffer range, constraints on distributions commence once the distribution is declared. That is, constraints on subsequent distributions apply following the distribution that would result in an ADI being in the capital buffer range. The existing requirement that any reductions in capital, as detailed in APS 110, are subject to approval by APRA remains.
40. Should an event occur, such as a material financial loss, that results in an ADI's CET1 capital ratio falling within the capital buffer range, constraints would commence immediately with any subsequent distributions declared or determined being subject to constraint. As detailed in paragraph 29 of APS 110, an ADI may apply to APRA to make payments in excess of the constraints imposed by the capital conservation buffer regime. In considering whether to approve such an application, APRA would expect an ADI to

demonstrate that it has a capital plan that details the measures the ADI will take to raise capital equal to or greater than the amount above the constraint that the ADI wishes to distribute. In the absence of APRA's approval of such a capital plan an ADI's distributions would be constrained. Constraints on future distributions will continue to apply until such time as the ADI is no longer in the capital buffer range.

Period of earnings

41. The period for determining constraints on distributable profits is continuous. That is, an ADI would determine a robust internal estimate of its earnings, as close as practically possible, for the 12-month period immediately preceding the announcement of any distribution.

Period of constraints

42. Once an ADI's CET1 capital ratio falls within the capital buffer range, constraints would continue to apply until the ADI's CET1 capital ratio was no longer within the capital buffer range. APRA expects that an ADI would calculate its CET1 capital ratio, in relation to each distribution, to ascertain whether or not it was within the capital buffer range. This calculation would be based on the most current information readily available to the ADI. If an ADI was already within the capital buffer range and, on recalculating its CET1 capital ratio, it has moved further into/out of the capital buffer range (i.e. into a higher/lower quartile), then the more/less restrictive capital conservation ratio would apply to the distribution being made. If, on recalculating its CET1 capital position, an ADI establishes it is no longer in the capital buffer range then the constraints would no longer apply, with immediate effect.

Appendix A

Table 1: Identifying jurisdictional location of exposures: ‘ultimate risk’ versus ‘immediate risk’

	Ultimate risk	Immediate risk
Borrower located in jurisdiction A:		
No collateral/hedge	A	A
Collateral located in jurisdiction A	A	A
Hedged/guaranteed with counterparty located in jurisdiction A	A	A
Borrower located in jurisdiction A:		
Collateral located in jurisdiction B	B	A
Hedged/guaranteed with counterparty located in jurisdiction B	B	A
Is a branch of parent located in jurisdiction B	B	A
Repo transaction with counterparty in jurisdiction A (independent of jurisdictional location of risk of collateral)		
	A	A
Securitisation exposures issued in jurisdiction A:		
Debtor of the underlying exposure is located in jurisdiction A	A	A
Debtor of the underlying exposure is located in jurisdiction B	B ¹	A
Project finance; borrower in jurisdiction A with project located in jurisdiction B		
	B	A
Collective investment undertakings located in jurisdiction A		
	Depends on whether the ADI has a debt or equity claim on the investment vehicle ²	A
Trading book exposures to jurisdiction A:		
Standardised approach	A	A
Advanced approach	A	A

¹ Based on a ‘look-through’ approach, whereby the jurisdiction of ultimate risk is defined as the residence of the debtor of the underlying credit, security or derivatives contract. If this cannot be implemented the jurisdiction of ‘immediate risk’ should be used.

² Where the ADI has a debt claim on the investment vehicle, the ultimate risk exposure should be allocated to the jurisdiction where the vehicle (or, if applicable, its parent / guarantor) resides. If the ADI has an equity claim, the ultimate risk exposure should be allocated proportionately to the jurisdictions where the ultimate risk exposures of the vehicle reside.

Appendix B

Table 2: Calculating the ADI-specific buffer for an ADI using the internal ratings-based approach to credit risk

Note: This table is illustrative only and it is open to an ADI to use an alternative approach.

		Jurisdiction				Total
		A	B	C	D	
Trading book private sector credit exposures						
T1	Specific risk charge	\$6	\$3	\$3	\$4	
T2	Incremental risk charge	\$3	\$1	\$2	\$2	
T3	Comprehensive risk charge	\$2	-	-	\$2	
T4	Securitisation charge	\$1	-	\$1	-	
T5	Market risk capital charge (T1 + T2 + T3 + T4)	\$12	\$4	\$6	\$8	
T6	Trading book RWA (T5 * 12.5)	\$150	\$50	\$75	\$100	\$375
Banking book private sector credit exposures						
B1	Total on- and off-balance sheet credit RWA	\$1,155	\$700	\$800	\$900	
B2	On- and off-balance sheet RWA for sovereign credit exposures	\$5	\$10	\$25	\$50	
B3	On- and off-balance sheet RWA for bank credit exposures	\$25	\$30	\$40	\$100	
B4	Securitisation exposures	\$60	\$35	\$55	\$50	
B5	Banking book RWA (B1 - B2 - B3 + B4)	\$1,185	\$695	\$790	\$800	\$3130
W	RWA for all private sector credit exposures (T6 + B5)	\$1,335	\$745	\$865	\$900	\$3845
X	Geographical weight (Wi/total W)	34.72%	19.38%	22.50%	23.41%	100%
Y	Jurisdictional buffer as set by national authorities	2.50%	1.25%	0.00%	1.75%	
	ADI-specific buffer (X * Y)	0.87%	0.24%	0.00%	0.41%	1.52%
	RWA for total exposures ¹					\$4,500
	Countercyclical capital buffer (1.52% * \$4,500)					\$68.39

¹ Includes all credit and market risk, operational risk, CVA risk, etc.

Table 3: Calculating the ADI-specific buffer for an ADI using the standardised approach to credit risk

Note: This table is illustrative only and it is open to an ADI to use an alternative approach.

		Jurisdiction				Total
		A	B	C	D	
Trading book private sector credit exposures						
T1	Specific risk charge	\$3	\$1	\$0	\$1	
T2	Securitisation charge	\$1	\$2	\$1	\$0	
T3	Market risk capital charge (T1 + T2)	\$4	\$3	\$1	\$1	
T4	Trading book RWA (T3 * 12.5)	\$50	\$37.50	\$12.50	\$12.50	\$112.50
Banking book private sector credit exposures						
B1	Total on-balance sheet credit RWA	\$3,000	\$1,000	\$500	\$350	
B2	Total claims on central, territory or state governments, central banks	\$1,000	\$400	\$300	\$100	
B3	Total claims on local governments and non-commercial public sector entities	\$50	\$40	\$10	\$10	
B4	Total claims on international banking agencies and multilateral regional development banks	\$0	\$0	\$0	\$10	
B5	Total claims on ADIs and banks	\$600	\$300	\$100	\$40	
B6	Securitisation exposures	\$100	\$100	\$0	\$0	
B7	On-balance sheet banking book RWA (B1 - B2 - B3 - B4 - B5 + B6)	\$1,450	\$360	\$90	\$190	\$2,090
B8	Total non-market-related and market-related off-balance sheet risk-weighted credit exposures	\$480	\$240	\$80	\$30	
B9	Off-balance sheet risk-weighted credit exposures to governments and banking institutions (non-market-related and market-related)	\$300	\$150	\$70	\$10	
B10	Off-balance sheet private sector credit exposures (B8 - B9)	\$180	\$90	\$10	\$20	
B11	Off-balance sheet securitisation exposures	\$20	\$30	\$0	\$10	
B12	Off-balance sheet banking book RWA (B10 + B11)	\$200	\$120	\$10	\$30	\$360
B13	Banking book RWA (B7 + B12)	\$1,650	\$480	\$100	\$220	\$2,450

W	RWA for all private sector credit exposures (T4 + B13)	\$1,700	\$517.50	\$112.50	\$232.50	\$2,562.5
X	Geographical weight (Wi/total W)	66.34%	20.20%	4.39%	9.07%	100.00%
Y	Jurisdictional buffer as set by national authorities	2.50%	1.25%	0.00%	1.75%	
	ADI-specific buffer (X * Y)	1.66%	0.25%	0.00%	0.16%	2.07%
	RWA for total exposures ²					\$8,000
	Countercyclical capital buffer (2.07% * \$8,000)					\$165.58

² Includes all credit and market risk, operational risk, CVA risk, etc.



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