



# Prudential practice guide

APG 110 Capital Adequacy

June 2024

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# About this guide

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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.

*Prudential Standard APS 110 Capital Adequacy* (APS 110) sets out APRA's requirements for capital adequacy for authorised deposit-taking institutions (ADIs). This PPG, *Prudential Practice Guide APG 110 Capital Adequacy* (APG 110), aims to assist ADIs in complying with those requirements.

This PPG should be read in conjunction with APS 110 and *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110), as well as APRA's other prudential standards and associated guidance for ADI capital. Not all of the practices outlined in this PPG will be relevant for every ADI, and some aspects may vary depending upon the size, complexity and risk profile of the institution.

# Glossary

ADI	Authorised deposit-taking institution as defined in the <i>Banking Act 1959</i> .
APS 001	<i>Prudential Standard APS 001 Definitions</i>
APS 110	<i>Prudential Standard APS 110 Capital Adequacy</i>
APS 112	<i>Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk</i>
APS 113	<i>Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk</i>
APS 115	<i>Prudential Standard APS 115 Capital Adequacy: Standardised Measurement Approach to Operational Risk</i>
APS 116	<i>Prudential Standard APS 116 Capital Adequacy: Market Risk</i>
APS 120	<i>Prudential Standard APS 120 Securitisation</i>
APS 180	<i>Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk</i>
APS 330	<i>Prudential Standard APS 330 Public Disclosure</i>
Basel Committee	Basel Committee on Banking Supervision
Board	Board of directors
CCB	Capital conservation buffer
CCyB	Countercyclical capital buffer
CPG 110	<i>Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review</i>
D-SIB	An ADI that has been determined by APRA to be a domestic systemically important bank.
IRB ADI	An ADI which has been approved by APRA to use the internal ratings-based (IRB) approach to credit risk.
Non-SFI	Non-significant financial institution, as defined in APS 001.
Prudential capital requirement (PCR)	The minimum amount of Regulatory Capital that an ADI or NOHC must hold, as defined in APS 110. Eligible Regulatory Capital is defined in <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i> .
Risk-weighted assets (RWA)	Determined in accordance with the relevant requirements of Attachment A to APS 110.
SA-CCR	Standardised approach to counterparty credit risk
SFI	Significant financial institution, as defined in APS 001.
Standardised ADI	An ADI which has not been approved by APRA to use the internal ratings-based approach to credit risk.

# Introduction

- 1) APS 110 sets out APRA's requirements for capital adequacy for ADIs. Under APS 110, ADIs must maintain adequate capital for the risks associated with their activities. The ultimate responsibility for the prudent management of capital rests with the ADI's Board.
- 2) This PPG provides guidance to assist ADIs in meeting the requirements of APS 110. It focuses on key aspects of the standard that are specific to ADIs: the operation of capital buffers, the countercyclical capital buffer, simplified requirements for small ADIs, the IRB capital floor and the leverage ratio.
- 3) This PPG should be read in conjunction with CPG 110, which provides Boards, senior management and other key stakeholders with broader guidance on capital management. CPG 110 focuses on the internal capital adequacy assessment process (ICAAP) and APRA's supervisory review process for capital.
- 4) This PPG should also be read in conjunction with APRA's other prudential standards and guidance for ADI capital management, where relevant. A summary of these is set out in Table 1 below.

Table 1. *APRA capital standards*

Standards	APRA code	Covers
Capital adequacy	APS 110	<b>Capital adequacy:</b> overarching requirements for maintaining capital adequacy and for capital management
Capital definitions	APS 111	<b>Measurement of capital:</b> criteria for measuring an ADI's regulatory capital, specifically the criteria that capital instruments must meet to qualify as Common Equity Tier 1 capital, Additional Tier 1 or Tier 2 capital
Credit risk	APS 112, APS 120, APS 180	<b>Standardised approach to credit risk:</b> measurement of credit risk capital requirements based on standardised risk weights, with associated capital requirements for securitisation and counterparty credit risk exposures
Credit risk modelling	APS 113	<b>Internal ratings-based approach to credit risk:</b> measurement of credit risk capital requirements based on advanced internal models
Operational risk	APS 115	<b>Standardised measurement approach to operational risk:</b> measurement of operational risk capital requirements
Market risk	APS 116, APS 117	<b>Market risk:</b> measurement of capital requirements for market risk and, for advanced ADIs, interest rate risk in the banking book

# Chapter 1 - Capital management

*This section provides guidance on APS 110 paragraphs 23-45, and Attachment B.*

## Minimum capital requirements

- 5) ADIs are subject to minimum prudential capital requirements (PCRs) under APS 110, as set out in Table 2. Minimum PCRs are set for different tiers of capital, namely Common Equity Tier 1 Capital (CET 1), Tier 1 Capital and Total Capital.

Table 2. *Minimum prudential capital requirements (PCR)*

Minimum requirements	Standardised	IRB	D-SIB
CET 1	4.5%	4.5%	4.5%
Tier 1	6%	6%	6%
Total Capital	8%	8%	8%

- 6) ADIs must maintain capital ratios above PCRs at all times. As required under APS 110 (paragraph 45), ADIs must inform APRA as soon as practicable where there are any significant departures from their ICAAPs, concerns about capital adequacy (including projected losses), or indications of significant adverse changes in market pricing.
- 7) Under APS 110 (paragraph 24), APRA may determine a higher PCR for an ADI at any time. Further detail on the process for any 'Pillar 2' supervisory adjustments to PCRs is set out in CPG 110.<sup>1</sup> There are a range of circumstances in which an adjustment may be required, including, but not limited to, where:
- a) capital requirements under the prudential standards do not fully address risks specific to the entity, such as strategic risk, reputation risk, concentration risk or other risks;
  - b) an entity has a higher risk business model or complex organisational structure, is newly licensed, or is making material changes to business mix; or
  - c) there are material concerns regarding weaknesses in governance or risk management, a failure to comply with prudential standards or inadequacies in capital management.
- 8) APRA may also adjust an ADI's PCR to ensure that there is sufficient loss-absorbing capacity for resolution. This would typically be implemented through an adjustment to an ADI's Total Capital PCR.

<sup>1</sup> The Basel Committee's framework for capital rests on three pillars. 'Pillar 1' is quantitative requirements for capital as set out in the prudential standards and measured in risk-weighted asset (RWA) terms. 'Pillar 2' is the supervisory review process, which includes supervision of risk management and may include adjustments to capital requirements. 'Pillar 3' is disclosure requirements designed to encourage market discipline.

- 9) An ADI must not disclose its individual PCR ratios, as required by APS 110 (paragraph 24). This approach is consistent across all ADIs, as disclosure by one may create pressure for disclosure by others. It is intended to manage the risk that disclosure could result in unintended or incorrect signalling, leading to financial instability at one or more ADIs.
- 10) A prudent ADI would discuss with APRA whether, and if so how, to disclose any material adjustments to 'Pillar 1' risk-weighted assets (RWA) requirements in public financial and regulatory reporting. If disclosed, good practice would be to clearly identify and explain the adjustment, including any associated corrective action being undertaken.

## Reductions in capital

- 11) Under APS 110 (paragraph 40), an ADI must obtain APRA's prior approval for any planned reduction in capital including a share buyback or where the aggregate amount of dividend payments on ordinary shares exceeds statutory after-tax earnings ('the profits test'). APRA's approval is required for a reduction in capital even in circumstances where there is a subsequent offsetting benefit to capital adequacy, such as the write-off of intangible items which may reduce CET 1 deductions.
- 12) An ADI proposing a reduction in capital must provide APRA with a forecast of its capital position extending for at least two years, as required by APS 110 (paragraph 42). Such a forecast would ideally include:
- capital projections at all tiers of capital;
  - supporting assumptions on the economic outlook, profitability, growth and other movements in RWA; and
  - the results of recent stress testing, demonstrating that capital would remain adequate in adverse conditions after the proposed reduction.
- 13) Although decisions to reduce capital can be time sensitive, a prudent ADI would ensure it allowed sufficient time for the supervisory review of the proposal in its planning.

## Regulatory capital buffers and management targets

- 14) ADIs are required to hold regulatory capital buffers above minimum CET 1 requirements, as set out in Table 3. There are three types of regulatory capital buffer: the capital conservation buffer (CCB), the additional CCB for domestic systemically important banks (D-SIB), and the countercyclical capital buffer (CCyB).<sup>2</sup> The regulatory capital buffer range is the sum of these regulatory capital buffers.

Table 3. *Regulatory capital buffers*

CET 1 (% RWA)	Standardised	IRB	D-SIB
Minimum PCR (refer Table 2)	4.50%	4.50%	4.50%
CCB	2.50%	3.75%	3.75%

<sup>2</sup> Refer to APRA's Information Paper, *Domestic systemically important banks in Australia* (December 2013): <https://www.apra.gov.au/news-and-publications/apra-releases-framework-for-domestic-systemically-important-banks-australia>.

Additional CCB for D-SIBs	-	-	1.00%
CCyB	1.00%	1.00%	1.00%
Total	8.00%	9.25%	10.25%

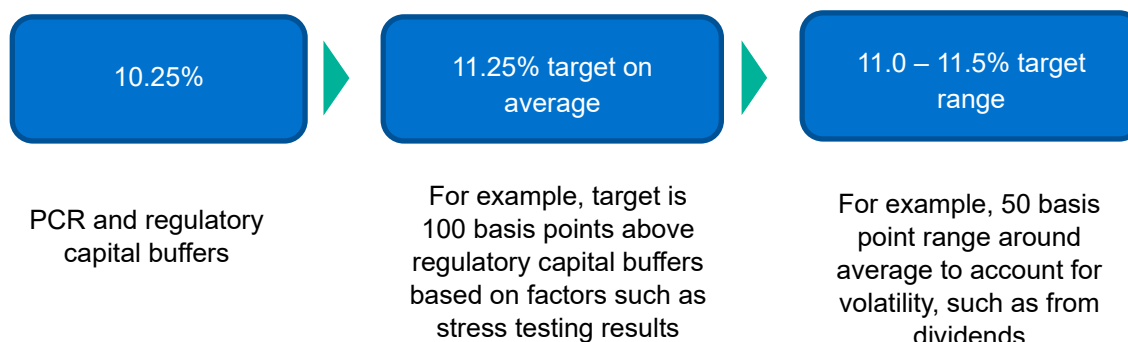
*Note: the CCyB may be set within a range of 0 - 3.5 per cent of RWA, with a baseline level of 1.0 per cent*

- 15) ADIs must have sufficient CET 1 to meet the regulatory capital buffer requirement, and cannot double-count for this purpose any amount of CET 1 that is already being used to meet minimum requirements for Tier 1 and Total Capital.<sup>3</sup>
- 16) APRA may also determine a PCR, CCB or CCyB expressed as a dollar amount, rather than, or in addition to, a ratio to RWA. This may be adopted, for example, in the early stages after licensing a new ADI.
- 17) A prudent ADI, in seeking to remain above minimum regulatory capital requirements, would set their own management targets for all tiers of capital. These management targets would typically be defined as a range to account for significant events that impact the level of an ADI's capital, such as dividend payments. A prudent ADI would ensure it maintains a management target that is adequately:
- in excess of regulatory capital buffers in stable operating conditions, to allow for business growth, volatility in RWA, profit and capital surplus, and dividend policy; and
  - sufficient to allow the ADI to withstand a severe but plausible downturn with capital ratios that remain above its PCR, calibrated based on regular stress testing.
- 18) APRA does not consider an ADI's management target in the same manner as a regulatory minimum or buffer. For example, no constraints on distributions are placed on an ADI for falling below its management target range, unlike if its capital ratio entered a regulatory capital buffer.
- 19) In the example below (based on an ADI deemed to be a D-SIB), the ADI operates with a management target range of 11.0 - 11.5 per cent, based on its average target level of 100 basis points above its PCR and regulatory capital buffers. APRA would not expect this ADI to set another buffer on top of the average target level of 11.25 per cent to avoid falling below it. However, a prudent ADI would have a good understanding of the steps it would take to return to its management target range if it fell below it.

<sup>3</sup> For example, an ADI with a minimum CET 1 of 4.5% and minimum Tier 1 of 6.0% would typically hold Additional Tier 1 (AT1) capital instruments of 1.5%. If this ADI only held AT1 of 1.0%, then it would need 0.5% in CET 1 to meet Tier 1 requirements, and 5.0% (4.5% + 0.5%) of its CET 1 would not be eligible to be used to meet the CCB requirement.



Figure 1. Example of setting a management target at a D-SIB

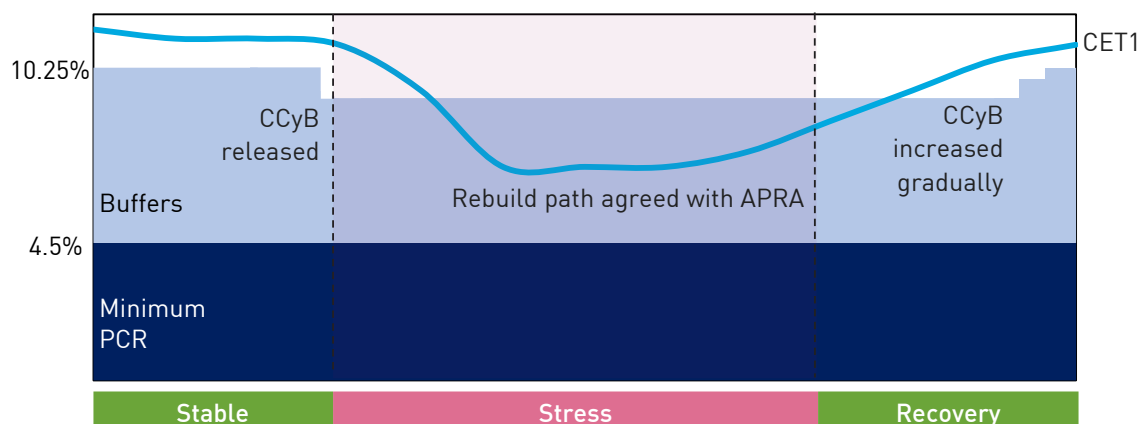


## Use of regulatory capital buffers in stress

- 20) APRA expects that an ADI would not normally operate with its capital ratio in the regulatory capital buffer range during stable conditions. Nor would APRA expect an ADI to make a discretionary distribution that takes its capital ratios into the buffer range.
- 21) An ADI may, however, operate with capital ratios within the regulatory capital buffer range during periods of stress, either idiosyncratic to itself or during a systemic stress event. Doing so is not a breach of prudential requirements. The regulatory capital buffers are designed to ensure that an ADI can absorb the impact of losses and continue to lend during periods of stress, without jeopardising the interests of depositors.<sup>4</sup>
- 22) It may not be possible or desirable for an ADI to operate with capital ratios within its management target range in a severe stress scenario. Especially in a systemic stress event, it is important that ADIs make use of the flexibility provided by the regulatory capital buffers to continue to lend to support households and businesses during periods of stress, rather than seek to unnecessarily conserve capital by restricting credit supply.
- 23) An illustration of how buffers may be used in a stress scenario is presented below, including a capital rebuild path that would be agreed with APRA. In such circumstances, a prudent ADI would conduct more regular stress testing, review, update and potentially initiate recovery plans and other contingency measures, and moderate capital distributions (including meeting any constraints of the regulatory capital buffer range).

<sup>4</sup> Buffers also accommodate changes in capital ratios from procyclicality in RWA. APRA expects that IRB ADIs would aim to avoid excessive procyclicality by, for example, adopting a through-the-cycle rating philosophy and modifying inputs in credit rating systems to remove excessive volatility. Further guidance on this is provided in APG 113.

Figure 2. Major bank capital ratios: use of buffers in stress



- 24) An ADI that is operating with capital ratios in the regulatory capital buffer range, or that expects to do so, would agree a capital restoration path back out of the range with APRA. To support this, a prudent ADI would provide capital projections, based on a range of scenarios and approved by the Board, to APRA.
- 25) The timeframe that APRA would expect an ADI to move out of the regulatory capital buffer range would depend on the nature and severity of the stress scenario, as well as a range of other factors. Such factors could include the outlook for the ADI's profitability, growth and capital, as well as the outlook for the industry and economy more broadly. During a prolonged or severe stress period, an ADI's restoration path out of the regulatory capital buffer range may be a year or more. During a milder or shorter period of stress, the restoration path may be able to be quicker than this.<sup>5</sup>

## Capital distributions

- 26) Capital distributions are those that impact CET 1, including dividends, share buybacks, dividend and interest payments on Additional Tier 1 instruments, and discretionary bonus payments to staff.<sup>6</sup>
- 27) Under APS 110 (paragraph 30), if an ADI's CET 1 capital ratio falls within the regulatory capital buffer range, maximum limits on capital distributions as a proportion of earnings come into effect. Earnings would typically be based on the most recent rolling 12-month period, unless otherwise determined by APRA.
- 28) The limits reduce as CET 1 capital ratios decline. These limits are set out in APS 110 (Attachment B). Examples are presented in Table 4, based on typical buffers for a Standardised ADI and a D-SIB.

Table 4. *Buffer range constraints*

Buffer range	Earnings that must be retained	Maximum earnings that can be paid out	Example 1: Standardised ADI CET 1	Example 2: D-SIB CET 1
Above the top	0%	100%	>8.0%	>10.25%

<sup>5</sup> APRA may impose limits on the period in which an ADI may operate within the regulatory capital buffer range, on a case-by-case basis, under APS 110 (Attachment B, paragraph 5).

<sup>6</sup> Payments that do not result in a depletion of CET 1 are not considered distributions for the purpose of calculating constraints under APS 110 (Attachment B).

Fourth quartile	40%	60%	>7.1%	>8.8%
Third quartile	60%	40%	>6.3%	>7.4%
Second quartile	80%	20%	>5.4%	>5.9%
First quartile	100%	0%	>4.5%	>4.5%

*Note: the CET 1 levels have been rounded. The examples here assume the CET 1 buffers as outlined in Table 4 above. APS 110 refers to minimum capital conservation ratios, which represents the proportion of earnings to be retained. An ADI may not make any distributions if it does not have positive earnings and is within the regulatory capital buffer range.*

- 29) In the example above, the maximum distribution for a D-SIB if its CET 1 ratio fell below 7.4 per cent would be 20 per cent of earnings.
- 30) A prudent ADI would, however, adopt a cautious approach to capital distributions during a period of stress even if it is operating above these levels. The Board of a prudent ADI would typically consider moderating dividend payout ratios, and considering the use of dividend reinvestment plans and other capital management initiatives to reinforce capital positions.<sup>7</sup>
- 31) An ADI may seek to raise capital in such conditions, such as through an issuance of new equity. In these circumstances, an ADI may apply to APRA to make payments in excess of limits in the regulatory capital buffer range, where it has a capital plan that details measures to raise capital equal to or greater than the amount it plans to distribute (as required under APS 110, paragraph 31). In assessing such an application, APRA would have regard to factors such as the likelihood of the capital raising being successful, the impact on the ADI's capital position and projections, market conditions, precedents for other ADIs, and the economic outlook.
- 32) The limits specified in APS 110 (Attachment B) continue to apply while an ADI is operating with capital ratios within the regulatory capital buffer range. If an ADI moves further into/out of the buffer range (into a higher/lower quartile), then the more/less restrictive constraint would apply. If an ADI rebuilds its CET 1 capital ratio above the top of the regulatory capital buffer range, then limits would immediately cease to apply.

<sup>7</sup> APRA may impose restrictions on capital distributions even where an ADI's CET 1 ratio is above the buffer range, under APS 110 (Attachment B, paragraph 4).

## Chapter 2 - Countercyclical capital buffer

*This section provides guidance on APS 110 Attachment C.*

- 33) The CCyB is designed to ensure that ADIs build up capital buffers to strengthen resilience as systemic risks are building, and provides additional flexibility to support economic activity in a downturn. It is one of APRA's core macroprudential policy tools.<sup>8</sup>
- 34) APRA's approach to operating the CCyB is outlined in the Information Paper, *The countercyclical capital buffer in Australia* (December 2015).<sup>9</sup> This details the objectives of the buffer, the approach to decision-making, indicators of the financial cycle, and communication plans. APRA's approach aligns with guidance on operating the buffer set out by the Basel Committee, including the use of the credit-to-GDP indicator as a guide rather than a determining factor in setting the Australian jurisdictional CCyB level.<sup>10</sup>
- 35) APRA has determined that the baseline level of the CCyB should be 1.0 per cent of RWA in normal times, and may vary this level within a range of 0 per cent to 3.5 per cent. APRA envisages that the Australian jurisdictional CCyB would be set:
- a) at the baseline level when systemic risk is neither particularly elevated or low;
  - b) above the baseline level when systemic risk is rising or elevated, with most increases to the CCyB typically incremental and with up to 12 months' notice provided before the higher level applies; or
  - c) below the baseline level during periods of system-wide stress and post-stress recovery, with any reductions in the level taking effect immediately.
- 36) APRA publishes a decision on the level of the Australian jurisdictional CCyB on an annual basis, although changes could be made at any point in the cycle.<sup>11</sup> To inform decisions on the level, APRA monitors a range of key indicators to determine whether systemic risks are heightened, including credit growth, asset prices, lending conditions and financial resilience.

### Determining the CCyB

- 37) An ADI that has private sector credit exposures solely in Australia would apply the jurisdictional CCyB set by APRA without adjustment.
- 38) For ADIs with private sector credit exposures in multiple jurisdictions, there is a more complex calculation to determine the CCyB. An ADI's specific CCyB is the weighted average of the jurisdictional CCyB levels set by

<sup>8</sup> For further detail on macroprudential policy, refer to APRA's Information Paper, *Macroprudential Policy Framework* (November 2021): <https://www.apra.gov.au/macroprudential-policy-framework>.

<sup>9</sup> Refer to APRA's Information Paper, *The countercyclical capital buffer in Australia* (December 2015): <https://www.apra.gov.au/capital-buffers>.

<sup>10</sup> Refer to the Basel Committee's *Guidance for national authorities operating the countercyclical capital buffer* (December 2010): <http://www.bis.org/publ/bcbs187.htm>.

<sup>11</sup> Refer to: <https://www.apra.gov.au/capital-buffers>.

regulators in the countries in which an ADI has private sector credit exposures. The weighting applied to each jurisdictional CCyB level is based on the proportion of the ADI's private sector credit RWA in that country.<sup>12</sup>

**Table 5. Example of determining CCyB for an ADI in multiple jurisdictions**

Illustrative example	Proportion of private sector credit RWA	Jurisdictional CCyB	ADI-specific CCyB
Australia	80%	1.0%	0.8%
New Zealand	10%	2.0%	0.2%
UK	5%	2.0%	0.1%
US	5%	0%	0.0%
Total	100%	-	1.1%

39) Under APS 110 (Attachment C, paragraphs 1-2), an ADI must include private sector credit exposures in all jurisdictions it has exposures in when calculating its ADI-specific CCyB. This includes countries 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 countries in which it has exposures, and to monitor the jurisdictional CCyB to be applied.<sup>13</sup> Under APS 110 (Attachment C, paragraph 4), APRA may require an ADI to apply a higher CCyB for a particular jurisdiction than has been determined by the relevant regulator in that country.

40) An ADI's specific CCyB does not need to include a sectoral CCyB in another jurisdiction that only applies to a sub-set of RWA. For example, a sectoral buffer applying only to housing loans in a foreign jurisdiction would not need to be recognised directly by an Australian ADI.

41) The table below defines private sector credit exposures for the purpose of the CCyB.

<sup>12</sup>For the CCyB calculation, credit RWA comprises private sector credit exposures and exposures for which an ADI calculates a trading book capital charge for specific risk. 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. The ADI-specific CCyB is the sum of each jurisdictional weight multiplied by the jurisdictional CCyB.

<sup>13</sup>The Basel Committee maintains a list of CCyB levels announced by member jurisdictions, and by some non-members, at <https://www.bis.org/bcbs/ccyb/index.htm>.

Table 6. *Definition of private sector credit exposures*

Includes	Excludes
<ul style="list-style-type: none"> <li>• 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</li> <li>• 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; and</li> <li>• exposures to financial sector counterparties (excluding banking institutions) and commercial public sector entities.</li> </ul>	<ul style="list-style-type: none"> <li>• exposures to banking institutions, such as ADIs, overseas deposit-taking institutions and other banking entities (international banking agencies and regional development banks); and</li> <li>• exposures to 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.</li> </ul>

42) Under APS 110 (Attachment C, paragraph 3), when determining the jurisdiction to which an exposure relates, an ADI must use an 'ultimate risk basis' (rather than immediate risk basis), where possible. The jurisdiction of ultimate risk is the jurisdiction of residence of the ultimate obligor, such as the guarantor of a financial claim, rather than where the exposure has been booked. *Reporting Standard ARS 731 International Banking Statistics* provides specific instructions for ADIs on identifying the jurisdiction of ultimate risk.

43) Under APS 110 (Attachment C, paragraph 2), an ADI must use the methodology for determining RWA set out in the relevant APRA prudential standards to determine the amount of its private sector credit exposures in an overseas jurisdiction, except for New Zealand. For New Zealand, in accordance with APS 112 and APS 113, an ADI must use the equivalent rules prescribed by the Reserve Bank of New Zealand.

44) To calculate private sector credit exposures in the trading book where standardised approaches are used for specific risk, an ADI must multiply the market risk capital charges below by 12.5 to determine the equivalent RWA:

- a) capital charges for equity specific risk;
- b) capital charges for interest rate specific risk for non-securitisation exposures;
- c) capital charges for securitisation correlation trading portfolios; and
- d) any other applicable capital charges for securitisation exposures in the trading book.

45) For positions where an internal models approach for specific risk is used, the relevant trading book capital charges would be determined based on an approach proposed by the ADI and agreed with APRA. The ADI must multiply these trading book capital charges by 12.5 to determine the equivalent RWA.

46) In planning capital as part of its ICAAP, a prudent ADI would project its ADI-specific CCyB, incorporating any changes expected in relevant jurisdictional buffers and private sector credit exposures.

47) Under *Prudential Standard APS 330 Public Disclosure (APS 330)*, an ADI must make certain disclosures related to its CCyB, including the geographic breakdown of its private sector credit exposures at a country level on an unweighted basis. A prudent ADI would also publish this information on a risk-weighted basis, and ensure that its public disclosures provide sufficient information to give users an understanding of the inputs used to determine the ADI-specific buffer.

# Chapter 3 - Simplified requirements

*This section provides guidance on simplified capital requirements for non-SFIs.*

48) Smaller, less complex ADIs may be eligible for simplified capital requirements. These ADIs are classified as non-significant financial institutions (non-SFIs), which are defined in APS 001.

## Simplified requirements

49) An eligible non-SFI is subject to simplified requirements for determining its risk-based capital ratio, as set out in APS 110 (Attachment A, paragraph 3) and summarised below.

**Table 7.** *Simplified capital ratio requirements and how they compare*

Total RWA is the sum of	Non-SFIs	SFI (Standardised)	SFI (IRB)
Credit	APS 112	APS 112	APS 113 <sup>14</sup>
Securitisation	APS 120	APS 120	APS 120
Counterparty credit	No requirement	APS 180	APS 180
Operational	10 per cent of credit and securitisation RWA	APS 115	APS 115
Market	No requirement	APS 116	APS 116
IRRBB	No requirement	No requirement	APS 117

50) Non-SFIs are also excluded from certain other capital requirements, as set out in the table below. APRA may remove the exclusion for one or more risk areas, where it deems that it is appropriate to do so based on the nature and risk of the non-SFI's business. For example, if a non-SFI ADI has a trading book, APRA may remove the exclusion for the market risk requirements under APS 116.

**Table 8.** *Exemptions and reduced requirements*

Risk area	Excluded or reduced requirement	Relevant standard
Operational Risk	10 per cent of credit and securitisation RWAs	APS 110, Attachment A

<sup>14</sup>An IRB ADI may determine RWA in accordance with APS 112 for those asset classes where it is required to use the standardised approach or where APRA has approved partial use.



Risk area	Excluded or reduced requirement	Relevant standard
Counterparty credit risk (CCR)	No counterparty credit risk capital requirements or reporting requirements under <i>Reporting Standard ARS 180.0 Counterparty Credit Risk</i>	APS 180
Market risk	No market risk capital requirements or reporting requirements under <i>Reporting Standard ARS 116.0 Market Risk</i>	APS 116
Interest rate risk in the banking book	No specific risk management requirements, with some reporting requirements	APS 117
Leverage ratio	No leverage ratio requirement under APS 110 or reporting requirements under <i>Reporting Standard ARS 110.0 Capital Adequacy</i>	APS 110, Attachment D
Disclosures	Centralised disclosures of key metrics by APRA on behalf of ADIs	APS 330

# Chapter 4 - IRB Capital floor

*This section provides guidance on APS 110 Attachment A (paragraph 4).*

- 51) IRB ADIs must calculate a capital floor for their IRB RWA as a proportion of Standardised RWA. This must be satisfied at Level 1 and Level 2. The aim of the floor is to ensure that the outcomes from the IRB and Standardised approaches do not excessively diverge.
- 52) An IRB ADI's total RWA is the greater of its total RWA calculated under the IRB approach and 72.5 per cent of the total RWA calculated under the standardised approach. That is, an IRB ADI's RWA cannot fall below 72.5 per cent of total RWA calculated under the standardised approach.
- 53) The capital floor applies at the aggregate RWA level and not at an asset class level. The figure below illustrates the components of the capital floor.

*Figure 3. Components of the IRB capital floor*



*Credit Risk includes Counterparty Credit Risk, Credit Valuation Adjustment and*

- 54) As set out in the table below, for some risk areas the numerator and denominator would be the same.

*Table 9. IRB floor calculation*

Floor calculation	Credit		Operational risk	Market risk	IRRBB
Numerator (IRB)	APS 113 <sup>15</sup>	APS 120, APS 180	APS 115	APS 116	APS 117
Denominator (Standardised)	APS 112	APS 120, APS 180	APS 115	APS 116 <sup>16</sup>	-
Method	IRB/ Standardised	Standardised/ Standardised	Standardised/ Standardised	IRB/ Standardised	IRB/ -

<sup>15</sup>Certain portfolios may be treated as Standardised, and the credit RWA would be the same for the numerator and denominator (such as margin lending).

<sup>16</sup>Under paragraph 5 of Attachment A to APS 110, during a transitional period, the capital charge for market risk would be the same for the numerator and denominator for an IRB ADI that uses an internal model approach to determine its market risk capital charge. This applies until 1 January 2025.

- 55) For the exposures of a banking subsidiary in New Zealand, an IRB ADI must use the rules prescribed by the Reserve Bank of New Zealand to determine its RWA under APS 112 and APS 113 for the purposes of the floor calculation.
- 56) Table 10 provides an illustrative example of the calculation of the capital floor by an IRB ADI. In this example, the IRB ADI's total RWA under the IRB approach (\$1300) is 71 per cent of its total RWA calculated under the standardised approaches (\$1830). This is less than the capital floor of 72.5 per cent so the IRB ADI must use \$1327 ( $\$1830 \times 72.5\%$ ) as its total RWA in calculating its risk-based capital ratios.

**Table 10. Example calculation of the capital floor**

Risk area	IRB approaches (\$RWA)	Standardised approaches (\$RWA)
Credit risk	1,050	1,600
Operational risk	180	180
Market risk	40	50
IRRBB	30	
Total RWA	1,300	1,830
IRB RWA / Standardised RWA		71%
Total RWA to be applied		1,327 (72.5%*1,830)

# Chapter 5 - Leverage ratio

*This section provides guidance on APS 110 Attachment D.*

57) An IRB ADI must maintain a minimum leverage ratio of 3.5 per cent under APS 110 (paragraph 37). The purpose of the leverage ratio is to complement the risk-based capital framework by limiting the overall leverage on an ADI's balance sheet. The table below sets out the calculation.

Table 11. *Leverage ratio*

Ratio	Numerator	Denominator
Definition	Tier 1 Capital	Exposure measure
Components	Tier 1 Capital	<ul style="list-style-type: none"><li>• On-balance sheet exposures</li><li>• Non-market related off-balance sheet exposures</li><li>• Derivative exposures</li><li>• Securities financing transaction (SFT) exposures</li></ul>

## On-balance sheet exposures

- 58) An ADI must include all balance sheet assets in calculating the exposure measure for its on-balance sheet exposures. This includes any on-balance sheet collateral for derivatives and SFTs, but excludes on-balance sheet derivatives and SFTs covered by the treatment for derivative exposures specified in APS 110 (Attachment D, paragraph 4).
- 59) Where an underlying asset being leased is a tangible asset, APRA expects an ADI to include a right of use asset in its Tier 1 Capital and exposure measure calculation for the leverage ratio. This appropriately reflects the economics of leasing transactions, including both the lessee's obligation to make future lease payments, as well as a right of use asset reflecting the lessee's control over the leased item's economic benefits during the lease term.
- 60) An ADI is expected to treat long settlement transactions and failed trades according to their accounting classification. For example, in calculating the exposure measure:
- a) if a long settlement transaction is classified as a derivative according to the Australian Accounting Standards, an ADI must apply the treatment for derivatives specified;
  - b) if a failed trade is classified as a receivable according to the Australian Accounting Standards, an ADI must apply the treatment for on-balance sheet exposures; or
  - c) if SFTs have failed to settle, an ADI must apply the treatment for SFT exposures.

## Derivative exposures

### Treatment of related collateral

- 61) An ADI must calculate its exposures associated with all derivative transactions as required by APS 110 (Attachment D, paragraph 16). In doing so, an ADI must not reduce its exposure measure by the amount of any derivatives collateral received from a counterparty, unless the conditions for treating the cash variation margin in paragraphs 23 and 24 of Attachment D to APS 110 are met. This means that an ADI cannot reduce the replacement cost by collateral received and that the multiplier is fixed at one for the purpose of the potential future exposure calculation under APS 110 (Attachment D, paragraph 20). However, the maturity factor in the potential future exposure (PFE) add-on calculation can recognise the PFE-reducing effect from the regular exchange of variation margin.
- 62) An ADI may reduce its exposure measure by treating the cash portion of the variation margin exchanged between counterparties as a form of pre-settlement payment. Cash variation margin exchanged on the morning of the subsequent trading day, based on the previous end-of-day market values, would meet the condition that variation margin is calculated and exchanged on a daily basis, based on mark-to-market valuation of derivative positions.

### Treatment of clearing services

- 63) If an entity falls outside of the Level 2 group of the ADI acting as a clearing member, then that entity would be considered a client and the treatment in APS 110 (Attachment D, paragraphs 25-27) would apply.

### Additional treatment for written credit derivatives

- 64) Under APS 110 (Attachment D, paragraph 30), a written credit derivative refers to a broad range of credit derivatives through which an ADI effectively provides credit protection, and is not limited solely to credit default swaps and total return swaps. This includes, for example, that all options where an ADI has the obligation to provide credit protection under certain conditions qualify as written credit derivatives.
- 65) The effective notional amount of such options sold by the ADI may be offset by the effective notional amount of options by which the ADI has the right to purchase credit protection which satisfies the conditions set out in APS 110 (Attachment D, paragraph 33).
- 66) An ADI may reduce the effective notional amount of a written credit derivative 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. The effective notional amounts included in the exposure measure may be capped at the level of the maximum potential loss, which means that the maximum potential loss at the reporting date is the notional amount of the credit derivative minus any negative fair value that has already reduced Tier 1 Capital.<sup>17</sup>
- 67) An ADI may reduce the effective notional amount through the application of offsetting purchased credit derivatives if the conditions in APS 110 (Attachment D, paragraph 33) are met. For the purposes of offsetting:

<sup>17</sup>For example, if a written credit derivative had a positive fair value of 20 on one date and has a negative fair value of 10 on a subsequent reporting date, the effective notional amount of the credit derivative may be reduced by 10. The effective notional amount cannot be reduced by 30. However, if on the subsequent reporting date the credit derivative has a positive fair value of five, the effective notional amount cannot be reduced at all.

- a) when a purchased credit derivative transaction exists, the effective notional amount of the written credit derivative may be reduced by any negative change in fair value reflected in Tier 1 Capital, provided that the effective notional amount of the offsetting purchased credit derivative is also reduced by any resulting positive change in fair value reflected in Tier 1 Capital; and
  - b) when a purchased credit derivative transaction exists, and the effective notional amount of the purchased credit derivative has not been reduced by any resulting positive change in fair value reflected in Tier 1 Capital, then the effective notional amount of the written credit derivative may only be offset if the effective notional amount of that written credit derivative has not been reduced by any negative change in fair value reflected in Tier 1 Capital.
- 68) An ADI can meet the condition in APS 110 (Attachment D, paragraph 33(a)) that the credit protection purchased is otherwise subject to the same, or more conservative, material terms as those in the corresponding written credit derivatives, if the strike price of the underlying purchased credit protection is equal to or lower than the strike price of the underlying sold credit protection.
- 69) The application of the same material terms condition under APS 110 (Attachment D, paragraph 33(a)) would result in the following treatments:
- a) for single name credit derivatives, the credit protection purchased through credit derivatives is on a reference obligation which ranks *pari passu* with or is junior to the underlying reference obligation of the written credit derivative. Credit protection purchased through credit derivatives that references a subordinated position may offset written credit derivatives on a more senior position of the same reference entity as long as a credit event on the senior reference asset would result in a credit event on the subordinated reference asset; and
  - b) for tranching products, the credit protection purchased through credit derivatives must be on a reference obligation with the same level of seniority.
- 70) One condition in APS 110 (Attachment D, paragraph 33(c)) is that 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. In making this determination, there does not need to be a legal connection between the counterparty and the underlying reference entity.
- 71) If an ADI writes credit protection through a credit derivative for a client, and enters into a back-to-back trade with a central counterparty whereby it purchases credit protection through a credit derivative on the same name, the purchased credit protection may be used to offset the written protection for the purposes of the leverage ratio. That is, an ADI may offset the effective notional amount of a written credit derivative sold to a client by means of a credit derivative on the same underlying name purchased from a central counterparty, provided that the criteria in APS 110 (Attachment D, paragraphs 32 and 33) are met.
- 72) APS 110 (Attachment D, paragraph 34) requires that credit protection purchased through a credit derivative on a pool of reference assets cannot offset a written credit derivative, unless both instruments reference the same pool of reference assets and the level of subordination of both transactions is identical. Tranching junior position hedges through credit derivatives that meet the following criteria would not be eligible for offsetting:
- a) the junior and senior tranches are on the same pool of reference entities;
  - b) the level of seniority of the debt of each of the reference entities in the portfolio is the same;

- c) the designated credit events for the credit protection sold on the senior tranche, and purchased on the junior tranche, are the same; and
- d) the anticipated economic recovery on the junior tranching protection purchased is equal to or greater than the anticipated economic loss on the senior tranching protection sold.

## SFT exposures

- 73) APS 110 (Attachment D, paragraph 43) sets out how an ADI that is acting as an agent in a SFT must calculate its exposure measure for this transaction.
- 74) One requirement is that an ADI must include a further exposure equal to the full amount of the security or cash in its exposures measure where the ADI is further economically exposed to the underlying security or cash in the SFT. This may be, for example, due to the ADI managing collateral received in the ADI's name or on its own account, rather than on the customer's or borrower's account (such as by on-lending or managing unsegregated collateral, cash or securities). However, this does not apply to client omnibus accounts that are used by agent lenders to hold and manage client collateral, provided that client collateral is segregated from the bank's proprietary assets and the bank calculates the exposure on a client-by-client basis.