



## **Prudential Standard APS 110**

### **Capital Adequacy**

#### **Objectives and key requirements of this Prudential Standard**

This Prudential Standard aims to ensure that authorised deposit-taking institutions maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities.

This Prudential Standard outlines the overall framework adopted by APRA for the purpose of assessing the capital adequacy of an authorised deposit-taking institution.

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

- have an Internal Capital Adequacy Assessment Process;
- maintain minimum levels of capital, at both Level 1 and Level 2 as appropriate; and
- inform APRA of any significant adverse changes in capital.

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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**) under the Banking Act, subject to paragraphs 3 and 11.
3. Except as provided by this paragraph, a foreign ADI, within the meaning of subsection 5(1) of the Banking Act, is not subject to this Prudential Standard. It must, however, be subject to comparable capital adequacy standards in its home country.
4. A reference to an ADI in this Prudential Standard shall be taken as 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.

Where an ADI to which this Prudential Standard applies is 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, subject to paragraph 11.

5. APRA may, in writing, approve an Extended Licensed Entity (**ELE**) in relation to an ADI. The ELE will comprise the ADI and each subsidiary of the ADI specified in the approval on a consolidated basis (refer to paragraph 10(a)(ii) and Attachment A).

## Responsibility for capital management

6. 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. The Board of directors (**Board**) of an ADI has a duty to ensure that the ADI maintains an appropriate level and quality of capital commensurate with the level and extent of risks to which the ADI is exposed from its activities. An ADI must have in place an Internal Capital Adequacy Assessment Process (**ICAAP**) that includes as a minimum:
  - (a) adequate systems and procedures to identify, measure, monitor and manage the risks arising from the ADI's activities on a continuous basis to ensure that capital is held at a level consistent with the ADI's risk profile; and

- (b) a capital management plan, consistent with the ADI's overall business plan, for managing the ADI's capital levels on an ongoing basis. Essentially, the plan must set out:
  - (i) the ADI's strategy for maintaining adequate capital over time, including outlining its capital target for providing a buffer against the risks involved in the ADI's activities, how the target level of capital is to be met and the means available for sourcing additional capital where required; and
  - (ii) actions and procedures for monitoring the ADI's compliance with minimum regulatory capital adequacy requirements, including the setting of trigger ratios to alert management to, and avert, potential breaches of these requirements.
- 7. An ADI must ensure its ICAAP is subject to effective and comprehensive review. The frequency and scope of the review must be appropriate to the ADI having regard to the size, business mix and complexity of the ADI's operations and the nature and extent of any change to its business profile and risk appetite. The ADI must, if requested by APRA, provide information on its ICAAP and any subsequent significant changes to its ICAAP.
- 8. An ADI that is a member of a conglomerate group (refer to Attachment B) could be exposed to risk, including contagion risk, through its association with other members in the group - that is, 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, must have regard to:
  - (a) group risks posed by other members in the group to the ADI;
  - (b) obligations, both direct and indirect, arising from the ADI's association with group entities that might give rise to a call on the capital of the ADI; and
  - (c) the ability to readily extract capital from another member in the group should the need arise to recapitalise the ADI or other group member. This includes consideration of the integration of the business within the group, the importance of subsidiaries to the group and the impact of taxation, regulatory requirements and other factors on the ability to realise investments in, or transfer surplus capital from, subsidiaries.
- 9. An ADI that heads a conglomerate group, in addition to maintaining adequate capital for the ADI, must satisfy APRA that the group as a whole has a level of capital consistent with the group's risk profile. To this end, the Board of an ADI that heads a conglomerate group must:
  - (a) establish policies on group capital adequacy (which have regard to the type and distribution of risk and capital resources held by the group) and implement a group capital management plan (with coverage similar to that outlined in paragraph 6(b)) to ensure that the group overall is adequately

capitalised to cover its risks and to meet regulatory, market and strategic needs;

- (b) ensure that appropriate systems and adequate procedures are in place to identify, assess, measure and monitor capital and group risks on a continuous basis; and
- (c) ensure that the group has sufficient capital freely available to meet unexpected losses and adverse shocks impacting on the group.

### Measurement of capital adequacy

10. APRA adopts a tiered approach to the measurement of an ADI's capital adequacy. It assesses the ADI's financial strength at three levels in order to ensure that the ADI is adequately capitalised, both on an individual and a group basis. These levels are:

(a) **Level 1** - either:

- (i) the ADI itself; or
- (ii) the ELE (refer to paragraph 5);

(b) **Level 2** - either:

- (i) if the ADI is not a subsidiary of an authorised NOHC and the ADI has subsidiaries in addition to those included in any ELE, the consolidation of the ADI and all its subsidiary entities other than non-consolidated subsidiaries (refer to Attachment C); or
- (ii) if the ADI is a subsidiary of an authorised NOHC, the consolidation of the immediate parent NOHC of the ADI and all the immediate parent NOHC's subsidiary entities (including any ADIs and their subsidiary entities) other than non-consolidated subsidiaries (refer to Attachment C)

unless APRA otherwise determines, in writing, a different Level 2 composition for a group of companies of which the ADI is a member; and

(c) **Level 3** - the conglomerate group at the widest level (refer to Attachment B).

11. For the purposes of this Prudential Standard, Level 1 and Level 2 requirements apply in accordance with the schedule set out below.

Corporate structure	Level 1	Level 2
ADI with no ELE	ADI must meet the requirements of this Prudential Standard on	

<b>Corporate structure</b>	<b>Level 1</b>	<b>Level 2</b>
	a Level 1 basis (refer to paragraph 10(a)(i)).	
ADI forming part of an ELE	ADI must ensure that the requirements are met collectively by the ELE on a Level 1 basis (refer to paragraph 10(a)(ii)).	
ADI not a subsidiary of an authorised NOHC		ADI must ensure that the requirements are met on a Level 2 basis (refer to paragraph 10(b)(i)).
ADI is a subsidiary of an authorised NOHC		Authorised NOHC must ensure that the requirements are met on a Level 2 basis (refer to paragraph 10(b)(ii)).

12. Level 1 assessments are applicable to all ADIs. Level 2 assessments are applicable to ADIs that are members of a Level 2 group (refer to paragraph 10(b)). Level 3 assessments only apply to ADIs and authorised NOHCs prescribed, in writing, by APRA and the conglomerate groups they head (refer to Attachment E).
13. Measurement of an ADI's capital adequacy is based on:
- (a) Level 1 and Level 2 – a risk-based capital adequacy framework aligned with the Basel II Framework (refer to Attachment D); and
  - (b) Level 3 – the methodology approved by APRA (refer to Attachment E).

### **Minimum capital adequacy requirements**

14. An ADI is subject to a prudential capital ratio (**PCR**) as determined by APRA. Subject to paragraphs 15 and 16, an ADI's PCR is eight per cent of its total risk-weighted assets, half of which must be held in the form of Tier 1 capital. An ADI must, at all times, maintain a risk-based capital ratio in excess of its PCR. For the definition of total risk-weighted assets and risk-based capital ratio, refer to Attachment D.
15. APRA may, in writing, increase an ADI's PCR to a specified level above eight per cent where APRA believes there are prudential reasons for doing so (refer to Attachment F). In doing so, APRA may specify the same or different PCRs at

Level 1 and Level 2, or increase the PCR at only one level. Where APRA requires an ADI to maintain a PCR above eight per cent, a minimum of half the capital required to meet the PCR must be held in the form of Tier 1 capital, unless APRA determines otherwise.

16. APRA may, in writing, require an ADI to hold:
  - (a) more than 50 per cent of its required PCR in the form of Tier 1 capital; or
  - (b) a greater proportion of its Tier 1 capital in the form of Fundamental Tier 1 capital than the proportion required by *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*.<sup>1</sup>
17. An ADI must, as part of its ICAAP, establish and maintain in the normal course of business risk-based capital ratios (refer to Attachment D) for both Tier 1 capital and the capital base,<sup>2</sup> above the PCR (or PCRs) prescribed under this Prudential Standard.
18. An ADI subject to Level 3 capital adequacy assessment must meet the minimum group-wide capital adequacy benchmarks, approved by APRA, on a continuous basis. APRA may, under paragraph 15, impose higher capital requirements on an ADI in a conglomerate group if it is not satisfied with the group's capital adequacy at Level 3.

### **Reductions in capital**

19. An ADI must obtain APRA's written consent prior to making any planned reduction in its capital, whether at Levels 1, 2 or 3 (refer to Attachment G).

### **Notification requirements**

20. An ADI and an authorised NOHC (as applicable) must inform APRA, in accordance with section 62A of the Banking Act, of any breach or prospective breach of the minimum capital adequacy requirements contained in this Prudential Standard and APS 111 and remedial actions taken or planned to deal with the breach.
21. An ADI and an authorised NOHC (as applicable) must inform APRA as soon as practicable of:
  - (a) any significant departure from its ICAAP (refer to paragraphs 6 and 9);
  - (b) any concerns it has about its capital adequacy, whether at Level 1, 2 or 3, along with proposed measures to address these concerns; and
  - (c) any significant adverse changes in its capital, whether at Level 1, 2 or 3.

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<sup>1</sup> In this Prudential Standard, 'Fundamental Tier 1 capital' has the meaning in APS 111.

<sup>2</sup> In this Prudential Standard, 'capital base' has the meaning in APS 111.

## Attachment A

### Extended Licensed Entity

1. APRA may, subject to the specific requirements set out in paragraph 3 of this Attachment, allow an ADI<sup>3</sup> to treat one or more of its subsidiaries, other than an entity regulated directly by APRA or by an equivalent regulator overseas, as part of the ADI itself for the purposes of measuring the ADI's capital adequacy and exposures to related entities. This requires APRA to adopt a "substance over form" approach and to "look through" the legal structure involved. Under this approach, an ADI and all its eligible subsidiary entities are "consolidated" to form an ELE for measuring the ADI's capital adequacy and its exposures to all other related entities. Accordingly, the ADI's exposures to these subsidiaries, including equity investments, are exempted from the ADI's capital adequacy limits on equity and capital investments and intra-group exposure limits prescribed by APRA.
2. An ADI may apply to APRA to have one or more subsidiaries approved as part of its ELE. APRA will seek to identify, in consultation with the ADI, entities that are eligible for approval as part of the ELE. An ADI must inform APRA as soon as it becomes aware that a member of the ELE no longer meets the criteria set out in this Attachment. A subsidiary that no longer meets the criteria will cease to form part of the ELE.
3. APRA will, in deciding whether to approve a subsidiary of an ADI for inclusion within the ELE, have regard to the extent of the ADI's control over, and integration with, the subsidiary as well as the existence of any third-party liabilities of the subsidiary. Potential complications that might arise if underlying asset holdings have to be liquidated during financial stress will also be considered. The following criteria must be met in respect of the relationship between the ADI and the subsidiary:
  - (a) the subsidiary is wholly owned by the ADI, with a Board that is composed entirely of members of the ADI's Board or senior management;
  - (b) the ADI has complete information on the individual assets, liabilities and off-balance sheet positions of the subsidiary. The ADI must have access to the stand-alone accounting records for the subsidiary, and must be able to provide APRA with full and unfettered access to these and any other information at any time, including during on-site visits;
  - (c) the ADI has unrestricted control over the composition of the subsidiary's assets and liabilities. The ADI must demonstrate to APRA that there are no legal or regulatory barriers, including cross-border issues where the subsidiary is not incorporated or established in Australia, to the transfer of any assets or funds back to the ADI. There must be no legal obstacle to

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<sup>3</sup> For the avoidance of doubt, a reference to an ADI in this Attachment means an ADI as defined in section 5 of the Banking Act, rather than an ELE.



the ADI instituting a wind-up of the subsidiary at any time and placing the remaining assets on the balance sheet of the ADI;

- (d) the ADI manages the assets and liabilities of the subsidiary as part of its internal management practices. This includes reporting structures, accounting processes, audit arrangements and risk management and measurement systems. The ADI's risk management processes, management information systems and internal controls must be fully extended to the operations of the subsidiary. The senior management of the ADI must monitor the operations of the subsidiary to the same extent as the operations of the ADI itself. Systems for monitoring and control over the subsidiary must be included within the internal and external audit programs of the ADI;
  - (e) the subsidiary must not conduct any business that the ADI is prevented from conducting under its authority to undertake banking business. The ADI must not use the ELE to circumvent APRA's prudential requirements;
  - (f) where the subsidiary holds or invests in assets, other than claims on the ADI, the subsidiary must have no material liabilities (either on-balance sheet or off-balance sheet) to entities other than those that are part of the ELE. Tax liabilities and employee entitlements are exempt from this requirement; and
  - (g) where the subsidiary borrows on behalf of the ADI, all funds must be on-lent directly to the ADI.
4. The requirements in this Attachment are based on a simple arrangement involving an ADI and one or more directly owned subsidiary entities. This is not intended to preclude, for example, an arrangement in which an ADI invests in a single entity as a holding company and that entity in turn invests in multiple entities. In these circumstances, and provided the holding company is assessed by APRA as meeting the ELE criteria, APRA will "look through" the holding company to determine whether individual entities meet all of the above criteria necessary to be included as part of an ELE. Entities that fail to meet the criteria will be excluded from the ELE.

## Attachment B

### Conglomerate group

1. For the purposes of this Prudential Standard, a conglomerate group is a group of companies that are related to each other within the meaning of section 50 of the *Corporations Act 2001* where the group includes one or more ADIs that have been incorporated within Australia.
2. Subject to paragraph 3 of this Attachment, unless determined in writing by APRA, a conglomerate group must be headed by an ADI or an authorised non-operating holding company (**authorised NOHC**) and may include non-financial (commercial) as well as financial entities (regulated and unregulated). A reference to a **regulated entity** in a conglomerate group refers to any entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas.
3. A foreign-owned locally incorporated ADI and its subsidiaries will constitute a conglomerate group for the purposes of this Prudential Standard. However, where a foreign-owned ADI has a locally incorporated NOHC parent, the conglomerate group will comprise the locally incorporated NOHC (even if it is not an authorised NOHC) and all its subsidiaries. The ADI's foreign parent(s), the foreign parent's overseas-based subsidiaries and their directly owned non-ADI entities operating in Australia will not form part of the conglomerate group. APRA, however, expects the foreign parent to be subject to regulatory oversight broadly consistent with that applied by APRA and, if requested by APRA, to provide APRA with information concerning activities of its subsidiaries outside the Australian conglomerate group.

## Attachment C

### Non-consolidated subsidiaries

1. For the purposes of determining an ADI's capital adequacy at Level 2, all banking and other financial activities (subject to paragraph 2 of this Attachment), both regulated and unregulated, conducted within the banking group must be consolidated.
2. Consolidation at Level 2 must cover the global operations of an ADI and its subsidiary entities, as well as any other controlled banking entities, securities entities and other financial entities, except for entities involved in the following business activities:
  - (a) insurance (including friendly societies and health funds);
  - (b) acting as manager, responsible entity, approved trustee, trustee or similar role in relation to funds management;
  - (c) non-financial (commercial) operations; and
  - (d) securitisation special purpose vehicles to which assets have been transferred in accordance with the requirements of *Prudential Standard APS 120 Securitisation*.

## Attachment D

### Risk-based capital adequacy framework

1. APRA's approach to the assessment of an ADI's capital adequacy is based on the risk-based capital adequacy framework set out in the Basel Committee on Banking Supervision's publication, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II Framework)*.
2. Consistent with the Basel II Framework, the approach provides for a quantitative measure of an ADI's capital adequacy and focuses on:
  - (a) the credit risk associated with an ADI's on-balance sheet and off-balance sheet exposures;
  - (b) the operational risk associated with an ADI's banking activities;
  - (c) the market risk arising from an ADI's trading activities;
  - (d) where applicable, the interest rate risk arising from normal financial intermediation, as distinct from trading activities (refer to *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (APS 117)*);
  - (e) the risks associated with securitisation in accordance with *Prudential Standard APS 120 Securitisation (APS 120)*; and
  - (f) the amount, form and quality of capital held by an ADI to act as a buffer against these and other exposures.
3. Under the risk-based capital adequacy framework, an ADI's capital adequacy is measured by means of a risk-based capital ratio calculated by dividing its capital base by its total risk-weighted assets. That is:

$$\text{risk-based capital ratio} = \frac{\text{capital base}}{\text{total risk-weighted assets}}$$

4. An ADI's PCR is the minimum risk-based capital ratio that the ADI must maintain.
5. The definition of **capital base**, including qualifying criteria for individual **components of capital**<sup>4</sup> to be included in an ADI's capital base, is set out in APS 111.
6. An ADI's **total risk-weighted assets** is calculated as the sum of:

<sup>4</sup> The term 'components of capital' is defined in APS 111.

- (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*;
- (b) risk-weighted assets determined under *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*;
- (c) 12.5 times the sum of the capital charges determined under *Prudential Standards APS 114 Capital Adequacy: Standardised Approach to Operational Risk*, *APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* and *APS 116 Capital Adequacy: Market Risk* and APS 117; and
- (d) risk-weighted assets determined under APS 120

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

7. If *Prudential Standard APS 150 Capital Adequacy: Basel II Transition (Advanced ADIs)* requires an ADI to calculate Basel II transitional floor adjusted RWA (**RWA(F)**), the ADI must substitute RWA(F) for total risk-weighted assets in paragraph 3 of this Attachment.

## Attachment E

### Level 3 assessment

1. Only ADIs or authorised NOHCs prescribed, in writing, by APRA, and the conglomerate group that they head, will be subject to Level 3 capital adequacy assessment. A conglomerate group headed by a prescribed ADI or authorised NOHC will constitute a **prescribed conglomerate group (PCG)** for the purposes of this Prudential Standard. APRA will identify PCGs for which it considers Level 2 assessment to be insufficient for measuring an ADI's capital adequacy on a group-wide basis. These could be financial conglomerates containing substantial banking and insurance activity, or mixed conglomerates containing significant banking and non-financial activity.
2. A **prescribed entity** (i.e. a prescribed ADI or prescribed authorised NOHC) must satisfy APRA that the PCG of which it is a part has sufficient capital (as defined in APS 111) for the risk profile of the group as a whole.
3. A PCG subject to Level 3 assessment must have a methodology, approved by APRA for measuring the group-wide capital adequacy that corresponds to its corporate structure. The methodology must have regard to all group members (whether ADIs, insurers or unregulated entities) and the capacity of any surplus capital to be transferred around the group according to need. The methodology may be based on the methodologies of the Joint Forum or the PCG's own internal capital estimation and allocation models.
4. The policies with regard to group capital adequacy at Level 3, including the methodology used to measure capital adequacy of the entire group, must form part of an ICAAP for the PCG.
5. A prescribed entity must ensure that the ICAAP for the PCG is subject to effective and comprehensive review. The frequency and scope of the review must be appropriate to the PCG having regard to the size, business mix and complexity of the PCG's operations and the nature and extent of any change to its business profile and risk appetite. The prescribed entity must, if requested by APRA, provide information on its ICAAP and any subsequent significant changes to its ICAAP.
6. In determining capital levels for the PCG, the Board of the prescribed entity must have regard to:
  - (a) the potential for risk to compound across the group, as well as any proven benefits of risk diversification;
  - (b) concentration of capital and risk within individual entities in the group;
  - (c) the capital needs of individual entities in the group;
  - (d) the nature of capital held by the group, including its maturity, servicing costs and any double counting or upgrading of capital within the group;

- (e) the ability to readily transfer surplus or free capital within the group and the type of capital which would be available to individual entities from other group members if required (this would involve consideration of the impact of taxation, regulatory requirements and other factors impinging on the ability to transfer surplus capital among individual entities); and
  - (f) the integration of business within the group and the ability of the group to readily realise capital through the sale of business lines and individual member entities without adversely impacting on the group's ongoing operations.
7. Unlike Level 1 and Level 2 capital adequacy assessments, there are no prescribed minimum capital adequacy requirements for Level 3 assessment. Instead, a prescribed entity of a PCG subject to Level 3 requirements must provide details of the PCG's own benchmarks and, on an ongoing basis, details of the extent to which the PCG falls short of these benchmarks.
8. APRA may impose additional or higher capital requirements on an ADI if APRA is not satisfied with the Level 3 capital adequacy assessment of a PCG to which it belongs.

## **Attachment F**

### **Higher Prudential Capital Ratios (PCRs)**

1. In assessing an ADI's overall capital adequacy, APRA may take into account other risk factors that have not been incorporated or accounted for in the risk-based capital adequacy framework, to ensure that the minimum capital adequacy requirements for the ADI are consistent with its overall risk profile. These factors include, for example, credit risk concentrations, profitability, liquidity, concentration of particular types of assets or liabilities and the effectiveness of the ADI's management systems for monitoring and controlling risks.
2. APRA may consider other factors, including the capital adequacy of subsidiaries of the ADI and any group headed by a holding company of an ADI, in deciding an ADI's PCR and the required minimum levels and composition of the ADI's Tier 1 capital and capital base. Newly established ADIs will generally be subject to a higher PCR in their formative years.



## Attachment G

### Planned reductions in capital

1. For the purposes of this Prudential Standard, a planned reduction in an ADI's capital, whether at Level 1, 2 or 3, includes:
  - (a) a share buyback or the redemption, repurchase or repayment of any qualifying Tier 1 and Tier 2 capital instruments issued by the ADI or by other entities included in the calculation of the ADI's Level 2 or Level 3 capital adequacy;
  - (b) trading in the ADI's own shares or capital instruments outside of any arrangement agreed with APRA in accordance with APS 111;
  - (c) payment of dividends on ordinary shares that exceeds an ADI's after-tax earnings, after including any payments on more senior capital instruments, in the financial year to which they relate (refer to APS 111); and
  - (d) dividend or interest payments (whether whole or partial) on Upper Tier 2 capital, Innovative Tier 1 capital and Non-innovative Residual Tier 1 capital that exceed an ADI's after-tax earnings, including any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year to which they relate (refer to APS 111).<sup>5</sup>
2. An ADI or authorised NOHC (as applicable) proposing a capital reduction (whether at Level 1, 2 or 3) must provide APRA a forecast showing, at the respective Levels, the projected future capital position (including PCR) after the proposed capital reductions. The forecast should extend for at least two years.
3. An ADI must satisfy APRA that the ADI's capital, at Level 1, 2 and 3 as appropriate, after the proposed reduction, will remain adequate for its future needs.

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<sup>5</sup> In this Prudential Standard, the terms 'Innovative Tier 1 capital' and 'Non-innovative Residual Tier 1 capital' have the meaning in APS 111.