

Banking (prudential standard) determination No. 3 of 2021

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Under subsection 11AF(1) of the *Banking Act 1959* (the Act), APRA has the power to determine standards (prudential standards), in writing, in relation to prudential matters to be complied with by authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised NOHCs). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 16 September 2021, APRA made Banking (prudential standard) determination No. 3 of 2021 (the instrument), which revokes *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* made under Banking (prudential standard) determination No. 4 of 2017 and determines a new *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111).

The instrument commences on 1 January 2022.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. In the case of the banking industry, APRA is empowered under the Act to issue legally binding prudential standards that set out specific prudential requirements with which ADIs must comply.

APRA regularly reviews its regulatory regime and amends its prudential requirements as a result of a number of factors including:

- international developments;
- changes in financial market conditions, or changes in risk management practices, in response to identified weaknesses in the prudential framework; and
- to reduce potential negative impacts of emerging industry issues.

An ADI's capital base is the cornerstone of its financial soundness. APS 111 is one of APRA's prudential standards relevant to an ADI's capital base and sets out detailed criteria for measuring an ADI's regulatory capital. Other than minor additions to the framework, APS 111 has not significantly changed since 2013.

Since 2013, there have been a number of changes to international standards and market conditions that have made it necessary for APRA to update APS 111. In particular, the Basel Committee on Banking Supervision (Basel Committee)¹ has released updated standards, statements and guidance on capital-related matters. Reforms by other overseas regulators, particularly the Reserve Bank of New Zealand (RBNZ), have also brought into focus risks associated with the capital treatment of banks' equity investments in their subsidiaries.

APRA has also sought to update, clarify and simplify APS 111, taking into account information contained in frequently asked questions (FAQs)² and findings from supervision. Complex capital issuance structures, which have not been a feature of market practice in recent years, have also been reviewed.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke APS 111 and to replace it with a new version of APS 111.

The new version of APS 111 is designed to:

- reinforce financial system resilience, through changes to the capital treatment of an ADI's equity investments in their banking and insurance subsidiaries;
- promote simple and transparent capital issuance, through the removal of the allowance for the use of special purpose vehicles (SPVs) and stapled security structures in regulatory capital issuance; and
- clarify aspects of APS 111, including provision of additional technical information to assist ADIs in issuing capital instruments.

The change to the capital treatment of an ADI's equity investments in their banking and insurance subsidiaries is the most material change to the Prudential Standard. The new version of APS 111 limits the amount of equity exposures in banking and insurance subsidiaries that can be leveraged to 10 per cent of an ADI's Common Equity Tier 1 (CET1) capital for each exposure.³ Amounts over this 10 per cent threshold are required to be deducted from CET1 capital. This treatment ensures there is adequate capital in Australian parent ADIs for banking subsidiaries (such as the New Zealand banking subsidiaries of Australia's major banks) and enhances the protection to the ADI's depositors.

¹ The Basel Committee on Banking Supervision, of which Australia is a member, is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Its members comprise central banks and bank supervisors from 28 jurisdictions.

² APRA Measurement of capital - frequently asked questions, updated June 2019 available at: [Measurement of capital - frequently asked questions | APRA](#)

³ CET1 capital is the highest quality component of capital. It is subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date. An example of CET1 capital is an ADI's ordinary shares.

Promoting simple and transparent capital issuance, through the removal of the allowance for the use of SPVs and stapled security structures, is consistent with the principle that capital instruments should be transparent and capable of being readily understood.

Clarifying aspects of APS 111, which comprise the bulk of the changes to APS 111, promotes certainty and comparability, which are key elements in the measurement and assessment of capital adequacy across all ADIs. Peer group comparisons with banks in other jurisdictions is also enhanced since regulators in these jurisdictions are also likely to take account of the Basel Committee's standards, statements and guidance.

Where APS 111 refers to an Act, Regulation, prudential standard, Australian Accounting Standard or Australian Auditing and Assurance Standard,⁴ this is a reference to the document as it exists from time to time, and which is available on the Federal Register of Legislation at www.legislation.gov.au.

APS 111 also incorporates by reference the *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* issued by the Financial Stability Board as it exists on 9 November 2015. This document is available at: [Total Loss-Absorbing Capacity \(TLAC\) Principles and Term Sheet - Financial Stability Board \(fsb.org\)](http://www.fsb.org).

The prudential standards provide for APRA to exercise various discretions. Decisions made by APRA exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

A breach of a prudential standard is a breach of the Act, as section 11AG of the Act provides that ADIs must comply with applicable prudential standards. However, there are no penalties prescribed for breach of a prudential standard. Instead, an ADI's breach of a provision in the Act is grounds for APRA to make further, substantive decisions under the Act in relation to the ADI. Those decisions are:

- to revoke an authority to carry on banking business (section 9A of the Act); and
- to issue a direction to the ADI, including a direction to comply with the whole or part of a prudential standard (section 11CA of the Act).

It is only at this stage that an ADI is exposed to a penalty: loss of its authority under section 9A or 50 penalty units if it breaches the direction (section 11CG of the Act). The subsequent substantive decisions of APRA to impose a direction or revoke an authority are subject to

⁴ Australian Accounting Standards is defined in *Prudential Standard APS 001 Definitions* (APS 001) as the Australian Accounting Standards issued by the Australian Accounting Standards Board as may be amended from time to time. Australian Auditing and Assurance Standards is defined in APS 001 as the Australian Auditing and Assurance Standards issued by the Auditing and Assurance Standards Board as may be amended from time to time. Under APS 001, the definitions in APS 001 apply to all prudential standards made under section 11AF of the Act unless the contrary intention appears.

merits review. In nearly all cases,⁵ the decisions are preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

3. Consultation

APRA has undertaken two rounds of public consultation in developing the new version of APS 111 and has also engaged with a variety of stakeholders over a period of 18 months, including individual ADIs, industry associations and other regulatory agencies.

APRA first consulted on proposed revisions to APS 111 in October 2019.⁶ APRA had planned to finalise APS 111 reforms in 2020, but delayed this to allow ADIs to focus on managing risks associated with COVID-19. APRA received seven submissions to the 2019 consultation.

In May 2021, APRA released a detailed response to issues raised by industry in the 2019 consultation.⁷ This included final policy positions.

As part of the May 2021 response, APRA also proposed some new minor revisions to APS 111 that were not included in the 2019 consultation. These revisions clarified that CET1 capital would not be permitted to have unusual features that could undermine its role as the highest quality loss absorbing capital, in line with the approach for other capital instruments. APRA received three submissions to this consultation.

In August 2021, APRA released a response to submissions to the May 2021 consultation which set out APRA's final policy positions in regard to the issues raised in these final submissions.⁸ APRA also released the final revised version of APS 111 at this time.

4. Regulation Impact Statement

In developing the new version of APS 111, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS), which satisfies the Office of Best Practice Regulation's requirements. The document evidencing APRA's policy development process has been lodged as supporting material.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

⁵ Subsection 9A(4) of the Act specifically provides that APRA does not need to consult where APRA is satisfied that doing so could result in a delay in revocation that would be contrary to the national interest or the interests of depositors with the ADI.

⁶ APRA Discussion paper - Revisions to APS 111 Capital Adequacy: Measurement of Capital, October 2019, available at: [Discussion paper - Revisions to APS 111 Capital Adequacy: Measurement of Capital | APRA](#)

⁷ APRA Response to submissions - APS 111 Capital Adequacy: Measurement of Capital, May 2021, available at: [Revisions to Prudential Standard APS 111 Capital Adequacy: Measurement of Capital | APRA](#).

⁸ APRA Letter to ADIs: Final revised Prudential Standard: APS 111 Capital Adequacy - Measurement of Capital, August 2021, available at: [Revisions to Prudential Standard APS 111 Capital Adequacy: Measurement of Capital | APRA](#)

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

ATTACHMENT A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Banking (prudential standard) determination No. 3 of 2021

The legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instrument

The purpose of the instrument is to revoke *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* determined by APRA in 2017 and replace it with a new *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*.

APS 111 sets out the characteristics that an instrument must have to qualify as regulatory capital for an authorised depository institution (ADI) and the various regulatory adjustments to be made to determine total regulatory capital for the ADI and its related companies. ADIs are bodies corporate that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia.

The new version of APS 111 is designed to:

- reinforce financial system resilience, through changes to the capital treatment of an ADI's equity investments in their banking and insurance subsidiaries;
- promote simple and transparent capital issuance, through the removal of the allowance for the use of SPVs and stapled security structures in regulatory capital issuance; and
- clarify aspects of APS 111, including provision of additional technical information to assist ADIs in issuing capital instruments.

Human rights implications

APRA has assessed the instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

Conclusion

The instrument is compatible with human rights as they do not raise any human rights issues.