

Banking (prudential standard) determinations Nos. 4, 6 and 7 of 2022

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 8 December 2022, APRA made the following determinations (collectively, the instruments):

- (1) Banking (prudential standard) determination No. 4 of 2022, which revokes *Prudential Standard APS 110 Capital Adequacy* made under Banking (prudential standard) determination No. 4 of 2015 and determines a new *Prudential Standard APS 110 Capital Adequacy* (APS 110);
- (2) Banking (prudential standard) determination No. 6 of 2022, which revokes *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* made under Banking (prudential standard) determination No. 2 of 2018 and determines a new *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112); and
- (3) Banking (prudential standard) determination No. 7 of 2022, which revokes *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* made under Banking (prudential standard) determination No. 6 of 2012 and determines a new *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113).

The instruments commence on 1 January 2023.

1. Background

APRA regulates banking, insurance and superannuation entities with the aim of ensuring that they can meet their financial promises to depositors, policyholders and superannuation fund members within a stable, efficient and competitive financial system. A key component of APRA's prudential framework is the suite of prudential standards that impose regulatory capital requirements (the capital standards) on ADIs for the purpose of ensuring ADIs hold sufficient capital to address the risks associated with their operations. As Australia is a member of the Basel Committee on Banking Supervision (Basel Committee) and the Group of 20, Australia and APRA are committed to meeting internationally agreed standards for prudential regulation for ADIs by implementing capital standards that are based on the framework agreed by the Basel Committee.

While Australian ADIs have traditionally been well capitalised to withstand shocks, the 2014 Financial System Inquiry recommended, and the Australian Government endorsed, that APRA increase capital requirements for ADIs such that they meet 'unquestionably strong' capital benchmarks. APRA set these capital benchmark increases for ADIs in 2017 and committed to reviewing its ADI capital standards to formally embed those increases. In addition, APRA identified a number of concerns that needed to be addressed in its review, including:

- concentration risks in the residential housing market in Australia;
- the alignment of capital and risk under the existing framework;
- ADIs' ability to compete in, and have access to, international markets; and
- regulatory burden faced by smaller, less complex ADIs.

APRA's new capital standards are designed to address these concerns and ensure that ADI capital ratios will continue to be 'unquestionably strong' on an aggregate basis. The 2014 Financial System Inquiry's recommendation that Australian banks should target the top quartile of internationally active banks was factored into the determination of the 'unquestionably strong' capital benchmarks. The new capital standards will increase the financial strength of ADIs and support the resilience of the Australian financial system. This helps to protect depositors, maintain market confidence and promote financial stability, especially during periods of financial stress. In addition, APRA's update of the capital standards is intended to:

- **increase flexibility:** through larger ADI capital buffers, in particular the introduction of a non-zero baseline level for the countercyclical capital buffer. This buffer ensures that APRA can adjust capital requirements in stress to support lending to the economy and to mitigate increasing systemic risk;
- **enhance risk sensitivity:** by aligning capital with risk, including through a reduction in capital requirements for lower risk residential mortgages and small business lending, and an increase in capital for higher risk mortgages. This aims to ensure that ADIs are sufficiently capitalised to withstand the risk arising from concentration in the residential housing market whilst incentivising prudent lending;
- **support competition:** by building in safeguards to ensure that capital requirements for advanced banks that use internal models do not become

excessively low relative to standardised banks that use APRA-prescribed risk weights;

- **improve transparency and comparability:** by increasing the alignment of APRA's capital standards with the international Basel framework. This includes making it easier to compare capital strength across advanced and standardised ADIs through better disclosure, including reporting required by advanced ADIs under the standardised approach to facilitate comparability. These changes will support the ability of ADIs to compete in and access international markets; and
- **increase proportionality:** through the introduction of simplified capital requirements for smaller, less complex ADIs relative to larger, significant financial institutions (SFIs) to lessen the regulatory burden.

2. Purpose and operation of the instruments

Banking (prudential standard) determination No. 4 of 2022

The purpose of this instrument is to revoke APS 110 and replace it with a new version of APS 110.

APS 110 aims to ensure that ADIs hold adequate capital on both an individual and group basis to act as a buffer against the risks associated with their activities. This instrument changes APS 110 in order to strengthen capital adequacy requirements for all ADIs whilst introducing more proportional requirements for smaller, less complex ADIs. The key changes to APS 110 are:

- **Larger regulatory buffers:** A countercyclical capital buffer (CCyB) will apply in an expanded range of 0 to 3.5 per cent of total risk-weighted assets (RWA). The actual level of the CCyB will be determined by APRA and communicated to entities. These settings will allow APRA to materially release capital requirements in times of stress, to support lending, and further increase capital requirements in response to increasing systemic risk.

A capital conservation buffer of 2.5 per cent will continue to apply to ADIs that use the standardised approach to credit risk, while 3.75 per cent will now apply for ADIs using the internal ratings-based approach (IRB) to credit risk. An additional 1.0 per cent will continue to apply for ADIs that are deemed by APRA to be domestic systemically important banks.

- **Capital floor:** Each IRB ADI will apply a capital floor that will result in its total RWA being at least 72.5 per cent of the total RWA calculated under the standardised approach. This is intended to avoid excessive divergence between the two approaches and is a key tool in supporting competition, whilst recognising that some divergence is appropriate to produce incentives for ADIs to invest in the IRB approach, which affords ADIs better risk management tools.
- **Simplified capital requirements:** A simplified set of capital requirements will apply to smaller, less complex ADIs, non-significant financial institutions (non-SFIs), which is intended to reduce regulatory burden. The eligibility criteria for the simplified capital requirements is set out in *Prudential Standard APS 001 Definitions*.

Banking (prudential standard) determination No. 6 of 2022 and Banking (prudential standard) determination No. 7 of 2022

The purpose of the instruments is to revoke APS 112 and APS 113 and to replace them with new versions of APS 112 and APS 113.

APS 112 and APS 113 require ADIs to hold sufficient regulatory capital against credit risk exposures. APS 112 applies to an ADI using the standardised approach to credit risk and APS 113 applies to an ADI with approval to use the internal ratings-based approach to credit risk.

The instruments make changes to APS 112 and APS 113 that will better align capital to the risks of various asset classes. These capital standards are broadly aligned with the Basel Committee's frameworks and where adjustments have been made to suit Australian conditions, APRA has done this in a more simple and transparent manner for the purposes of transparency and international comparability. The key changes to APS 112 and APS 113 are:

- **Residential mortgages segmentation:** APS 112 and APS 113 segment residential mortgages into lower and higher risk categories. Loans to owner-occupiers with principal-and-interest repayments are classified as lower risk, whereas higher risk residential mortgages include loans to investors, interest-only loans and loans to small businesses. Higher capital requirements apply to higher risk mortgages. This segmentation allows the capital standards to target key risks arising from ADI structural concentration in residential mortgage lending;
- **Small-business loans:** APS 112 and APS 113 reduce capital requirements for small business lending. The threshold for defining retail small businesses has been raised from \$1 million to \$1.5 million in loan size, increasing the volume of loans eligible for lower capital requirements. This is intended to enhance the incentives for ADIs to lend to small businesses where this can be prudently done;
- **Other changes:** APS 112 and APS 113 include a number of other changes. These changes seek to broadly align with the Basel Committee's segmentation, definitions and calibration of asset classes, however where needed the changes recognise Australian conditions and the objectives in the review of the ADI capital framework. Included in the changes are revisions to the definition of a 'commitment' and the values an ADI must use to convert commitments into on-balance sheet exposures for the purposes of applying capital requirements. APRA's changes aim to ensure that these exposures are appropriately accounted for in the capital standards to reduce the risk of undue shocks in stress.

Where APS 110, APS 112 and APS 113 refer to an Act, Regulation or prudential standard, 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 110, APS 112 and APS 113 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 such breaches. 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:

- (a) to revoke an authority to carry on banking business (section 9A of the Act); and
- (b) 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). In nearly all cases¹ the decision is preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

A decision of APRA to impose a direction is subject to merits review under section 11CA of the Act, which is appropriately available at the point where an ADI could be exposed to a penalty.

A decision of APRA to revoke an authority under the Act is subject to merits review, unless either:

- (a) APRA has determined that access to natural justice and merits review is contrary to the national interest or contrary to the interests of depositors with the ADI; or
- (b) the authority is an authority that is to cease to have effect on a day specified in the authority (section 9A(8) of the Act).

3. Consultation

APRA undertook extensive consultations on its proposed implementation of the ADI capital reforms between February 2018 to October 2021. Submissions were received from, and discussions held with, numerous ADIs, industry bodies, and peer regulators.

During consultation, APRA received a range of submissions on the quantum and type of capital buffers, the operation of capital buffers, and the segmentation and calibration of capital requirements across the standardised and IRB approaches. Submissions were broadly supportive of APRA's objectives but contained a number of suggestions to streamline requirements and support implementation.

¹ 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:

- (a) contrary to the national interest; or
- (b) contrary to the interests of depositors with the ADI.

A number of public discussion and response papers were released during and following the consultation periods, with draft standards accompanying the June 2019 and December 2020 response papers:²

- February 2018: Discussion paper *Revisions to the capital framework for ADIs*;
- August 2018: Discussion paper *Improving the transparency, comparability and flexibility of the ADI capital framework*;
- June 2019: Response paper *Revisions to the Capital Framework for ADIs*;
- December 2020: Response paper *A more flexible and resilient capital framework for ADIs*;
- November 2021: Response paper *Finalising Bank Capital Reforms* and Information Paper *An Unquestionably Strong Framework for Bank Capital*; and
- July 2022: Response paper *Finalising Bank Capital Guidance*

4. Regulation Impact Statement

In revising APS 110, APS 112 and APS 113, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS), which satisfies the Office of Impact Analysis's requirements. APRA's policy development process is evidenced in Annex D of *Response to Submissions – Finalising the Bank Capital Reforms*, published 29 November 2021.³ An extract of Annex D has been lodged as supporting material.

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

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.

² Refer to [Revisions to the capital framework for authorised deposit-taking institutions | APRA](#).

³ Refer to: [Response to submissions - Finalising bank capital reforms \(apra.gov.au\)](#).

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) determinations Nos. 4, 6 and 7 of 2022

The legislative instruments (the instruments) are 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 Instruments

The purpose of the instruments is to revoke *Prudential Standard APS 110 Capital Adequacy* (APS 110), *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) and replace them with new versions of APS 110, APS 112 and APS 113.

APS 110 sets out requirements for an authorised deposit-taking institution (ADI) to maintain adequate capital on both an individual and group basis to act as a buffer against the risks associated with their activities. APS 112 and APS 113 require ADIs to hold sufficient regulatory capital against credit risk exposures. ADIs are bodies corporate that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia.

Human rights implications

APRA has assessed the instruments and is of the view that they do 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 instruments are compatible with human rights as they do not raise any human rights issues.