Banking (prudential standard) determination No. 7 of 2024

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 27 November 2024, APRA made Banking (prudential standard) determination No. 7 of 2024 (the instrument), which revokes *Prudential Standard APS 116 Capital Adequacy: Market Risk* made under Banking (prudential standard) determination No. 9 of 2022 and determines a new *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116).

The instrument commences on 1 January 2025.

## 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.

One of the key components of APRA’s prudential framework is the suite of prudential standards which require ADIs to hold regulatory capital as a buffer against the risks which they undertake (capital standards). These capital standards include APS 116.

Australia is a member of the Basel Committee on Banking Supervision (BCBS) and is committed to meeting internationally agreed standards for the prudential regulation of banks. APS 116 follows closely the principles underpinning the BCBS’s Market Risk standards, with appropriate Australian adjustments.

Banks have portfolios of traded instruments for short-term profits. These portfolios – referred to as trading books – are exposed to market risk, or the risk of losses resulting from changes in the prices of instruments such as bonds, shares and currencies.

APS 116 requires ADIs engaging in activities that give rise to risks associated with potential movements in market prices to adopt risk management practices and hold regulatory capital that is commensurate with the risks involved.

APS 116 applies to ADIs that have trading books or foreign exchange or commodity positions. It does not apply to foreign ADIs or purchased payment facility providers.

## Purpose and operation of the instrument

The purpose of the instrument is to revoke the existing APS 116 and replace it with a new version of APS 116. The new version makes minor amendments including:

* the addition of a paragraph in regard to previous exercise of discretion. This addition is intended to bring APS 116 in line with the prudential framework and requires an ADI to contact APRA if it seeks to place reliance, for the purposes of complying with APS 116, on a previous exemption or other exercise of discretion by APRA under a previous version of APS 116; and
* replacing a reference to *Prudential Standard APS 001 Definitions* with the recently finalised definitional prudential standard, *Prudential Standard CPS 001 Defined terms.*

The changes to APS 116 are part of the minor framework update process, intended to ensure technical and clarifying changes to the prudential framework can be made in a timely manner. The updates are primarily technical clarifications and do not present any material change in policy settings.

Under APS 116, an ADI must have a framework to manage, measure and monitor market risk commensurate with the nature, scale and complexity of the institution’s operations; and use the standard method or an APRA-approved internal model approach to determine the institution’s capital requirement for market risk.

The standard method’s risk measurement is based on an exposure by exposure building block approach. Under the internal model approach, capital requirements are primarily determined using a value-at-risk (VaR) model.[[1]](#footnote-2)

APS 116 supports *Prudential Standard APS 110 Capital Adequacy*, which is a core standard in the Financial Resilience Pillar.

Details of the new APS 116 are set out in Attachment A to this Explanatory Statement.

### Documents incorporated by reference

Under paragraph 14(1)(a) of the *Legislation Act 2003*(the Legislation Act), APS 117 incorporates by reference the following documents as in force from time to time:

•           Acts of Parliament and associated delegated laws; and

•           Prudential Standards determined by APRA under subsection 11AF(1) of the Act.

These documents may be freely obtained on the Federal Register of Legislation at www.legislation.gov.au.

### Exercise of discretion by APRA

APRA’s prudential standards include powers that may be exercised by APRA that involves an element of discretion and that may affect the interests of the ADIs to which the prudential standards apply. These powers include a power to adjust or exclude a provision of the prudential standard.

The need to apply discretion is driven by entity-specific issues and circumstances that are not adequately addressed by the generally applicable provisions of the prudential standards. For example, adjustment or exclusion of a provision may be necessary to obtain a better prudential outcome than would be the case if the prudential requirement were applied unaltered to a particular regulated entity.

When exercising its discretion, APRA considers a wide range of factors when exercising its discretion, including the considerations set out in the Act and the *Australian Prudential Regulation Authority Act 1998*.

The exercise of APRA's powers is governed by a robust decision-making framework which is documented in APRA's internal policies. This framework supports APRA in fulfilling its mandate by limiting decision making to those senior APRA officers with the appropriate experience and skill to exercise prudent judgement. The framework also requires decision makers to seek advice from internal technical experts.

The power is also exercised following discussion with the relevant ADI about its appropriateness and the impact it may have on the entity.

### Review of decisions

Decisions made by APRA exercising powers in prudential standards are not themselves subject to merits review. However, they 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:

* 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). In nearly all cases[[2]](#footnote-3) 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:

1. 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
2. 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).

## Consultation

On 6 September 2024, APRA released for public consultation a set of proposed minor updates to the prudential framework. The purpose of the updates was to ensure that APRA’s prudential framework remains up to date in the intervening periods between comprehensive reviews of prudential standards. APRA finalised the proposed changes to APS 116 on 27 November 2024, following a one-month consultation period.

APRA received two submissions in response to its consultation on the minor updates, with non-confidential submissions available on APRA’s website. Respondents welcomed the changes to APS 116, given the objective of the amendments was to ensure APS 116 remains up to date.

APRA is satisfied the consultation was appropriate and reasonably practicable.

## Impact Analysis

The Office of Impact Analysis confirmed that a Regulation Impact Statement was not required.

## 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 B to this Explanatory Statement.

**ATTACHMENT A**

**Details of the new prudential standard**

The key requirements of APS 116 are set out below.

***Authority and application***

Under subsection 11AF(1) of the Act, APRA may determine prudential standards to be complied with by (among others) all, or specified classes of, ADIs and authorised NOHCs.

Paragraphs 1 to 4 are the machinery provisions relating to the legal authority under which the instrument is made, and the classes of ADIs and authorised NOHCs that are required to comply with the standard.

***Commencement and interpretation***

Paragraphs 5 to 6 are machinery provisions relating to the commencement and interpretation of the standard, and relevant definitions used in the standard.

***Scope***

Paragraph 7 details the scope of the standard, applying to all trading book positions and banking and trading book positions that give rise to foreign exchange or commodity risks.

Paragraph 8 excludes the treatment of counterparty credit risk capital requirements from APS 116.

***Definitions***

Paragraph 9 outlines the relevant definitions used in the standard.

***Key principles***

Paragraphs 10 to 14 outline the key principles of the standard, including: APRA approval of the ADI’s trading book policy statement, with positions in financial instruments allocated to the trading book if they are held with trading intent or in order to hedge other elements of the trading book; prudent valuation practices for trading book positions; robust risk measurement and management systems; and the requirement to hold capital against market risks arising from positions allocated to the trading book and all foreign exchange and commodity risks.

***The TFC capital requirement***

Paragraphs 15 to 16 require an ADI to calculate the TFC capital requirement using the standard method or the internal model approach or a combination of the standard method and the internal model approach, in which case the TFC capital requirement is the sum of the market risk capital requirements determined under the two methodologies.[[3]](#footnote-4)

***The standard method***

Paragraph 17 requires an ADI that does not have model approval must calculate its TFC capital requirement using the standard method as set out in Attachment B and, in relation to credit derivative instruments held in the trading book, Attachment D.

***The internal model approach***

Paragraphs 18 to 24 detail model approval from APRA in relation to market risk. An ADI’s model approval may specify how the internal model is to apply, including approvals under Attachment C. APRA’s prior written approval is required for any material changes to the market risk internal model. Prior notification to APRA is required for material changes to other components of the market risk management framework. APRA may also impose conditions on the model approval.

APRA may, at any time, vary or revoke a model approval, or impose additional conditions on the model approval if it determines that an ADI does not comply with the standard or it is appropriate, having regard to the particular circumstances of the ADI, to impose the additional conditions or make the variation or revocation.

***Combination of the internal model approach and the standard method***

Paragraphs 25 to 27 state that an ADI may, subject to APRA’s written approval, use a combination of the internal model approach and the standard method. In doing so, the ADI must comply with the requirements detailed in Attachment C.

***Previous exercise of discretion***

Paragraph 28 requires an ADI to contact APRA if it seeks to rely on an exercise of APRA’s discretion under a previous version of the standard.

***Attachment A Governance and the trading book policy statement and prudent valuation practices***

*Board and senior management responsibilities*

Paragraphs 1 to 2 of Attachment A outline the ADI’s Board of directors’ responsibilities for approving market risk strategies and ensuring that senior management takes the steps necessary to monitor and control these risks.

*The trading book*

Paragraphs 3 to 10 of Attachment A detail the requirements of an ADI to allocate to the trading book positions in financial instruments, including derivative products and other off-balance sheet instruments, that are held either with trading intent or to hedge other elements of the trading book.

Paragraphs 11 to 13 of Attachment A outline the requirements pertaining to an ADI’s trading book policy statement.

*Measuring currency exposure*

Paragraphs 14 to 17 of Attachment A set out what an ADI must include in its measurement of exposure to each currency in calculating the TFC capital requirement.

***Attachment B The standard method***

Paragraphs 1 to 2 of Attachment B covers the standard method, which comprises a range of alternative methodologies an ADI may use to calculate the market risks arising from its trading activities. The capital requirement under the standard method is the sum of the capital charges calculated in accordance with this Attachment and, for credit derivatives, Attachment D.

*Interest rate risk*

Paragraphs 3 to 41 of Attachment B details the capital charge for interest rate risk.

*Equity position risk*

Paragraphs 42 to 55 of Attachment B set out the standard method for measuring the risk of equity positions in the trading book, which applies to long and short positions in all instruments that exhibit market behaviour similar to equities.

Foreign exchange risk

Paragraphs 56 to 64 of Attachment B set out the standard method which also covers the risk of holding or taking positions in foreign currencies and gold. Where, however, an ADI is exposed to interest rate exposure on such positions, the ADI must include the relevant interest rate positions in the calculation of interest rate risk.

*Commodities risk*

Paragraphs 65 to 76 of Attachment B set out the standard method which also covers the risk of holding positions in commodities, including precious metals (excluding gold), where a commodity is defined as a tradeable physical or energy product, e.g. agricultural products, minerals (including oil), electricity and precious and base metals.

*Treatment of options*

Paragraphs 65 to 76 of Attachment B details the treatment of options and requires an ADI to obtain prior approval from APRA to use an approach to the treatment of options.

***Attachment C The internal model approach method***

*Key requirements*

Paragraphs 1 to 6 of Attachment C outline the internal model approach, which is based on the use of value-at-risk (VaR) techniques. However, an ADI may seek APRA’s written approval to use a capital calculation methodology other than VaR. In addition, an ADI must calculate a ‘stressed VaR’ measure according to the requirements set out in paragraph 34 of Attachment C.[[4]](#footnote-5)

*General criteria*

Paragraphs 7 to 8 of Attachment C set out general criteria for an ADI using an internal model for regulatory capital purposes, including a requirement for a market risk management strategy that is conceptually sound and implemented with integrity, involving skilled staff, a proven track record of reasonable accuracy in measuring risk and regular stress testing.

*Qualitative standards*

Paragraphs 9 to 16 of Attachment C set out qualitative standards, including an independent risk control unit that is responsible for the design and implementation of the ADI’s market risk management system.

*Specification of market risk factors*

Paragraphs 17 to 27 of Attachment C set out the requirements for an ADI to specify, in its risk management system, an appropriate set of market risk factors (market rates and prices that affect the value of the ADI’s market related positions) that are sufficient to capture the risks inherent in the ADI’s portfolio of on-balance sheet and off-balance sheet trading positions.

*Quantitative standards*

Paragraphs 28 to 34 of Attachment C set out the quantitative criteria for the purpose of calculating the ADI’s capital charge.

*Stress testing*

Paragraphs 35 to 40 of Attachment C set out the requirements for an ADI to have a comprehensive stress testing program.

*Model review*

Paragraphs 41 to 42 of Attachment C set out what APRA will consider when reviewing an internal model (both prior to and after model approval), including whether the ADI’s internal validation processes are operating in a satisfactory manner.

*Treatment of specific risk*

Paragraphs 43 to 80 of Attachment C outlines the requirements associated with an ADI applying to APRA to use an internal model to calculate its specific risk capital requirement for equities and interest rate risk positions other than securitisation exposures and nth-to-default credit derivatives.

*Framework for the use of back-testing*

Paragraphs 81 to 87 of Attachment C set out the requirements for an ADI’s back-testing program, which must consist of a periodic comparison of its daily VaR measure (based on a one-day holding period) with the realised daily profit or loss (‘trading outcome’).

***Attachment D Treatment of credit derivatives in the trading book***

Paragraphs 1 to 2 of Attachment D require an ADI to determine the capital to be held against credit derivative instruments in the trading book in accordance with this Attachment.

*Application*

Paragraphs 3 to 5 of Attachment D outline the application of the Attachment to single name credit-default swaps, certain total-rate-of-return swaps, cash-funded credit-linked notes and first- and second-to-default baskets. It also outlines the approach to capital treatment where an ADI transacts more complex credit derivatives which fall outside the scope of this Attachment

*General principles - General market risk*

Paragraphs 6 to 7 of Attachment D requires an ADI that uses the standard method to treat credit derivatives based on a single reference entity in the same way as interest-rate-related derivatives (refer to Attachment B) for the purposes of calculating a general market risk capital charge.

*General principles - Specific risk*

Paragraph 8 of Attachment D set out the requirements for how an ADI must report for specific risk purposes.

*Credit-default swaps*

Paragraphs 9 to 10 of Attachment D set out the requirements where an ADI is a protection buyer and a protection seller in a credit-default swap.

*Total-rate-of-return swaps*

Paragraphs 11 to 12 of Attachment D set out the requirements where an ADI is a protection buyer and a protection seller in a total-rate-of-return swap.

*Cash-funded credit linked notes*

Paragraphs 11 to 12 of Attachment D set out the requirements where an ADI is a protection buyer and a protection seller in a cash-funded credit linked note.

*Nth-to-default basket credit derivatives*

Paragraphs 13 to 14 of Attachment D set out the requirements where an ADI is a protection buyer and a protection seller in a nth-to-default basket credit derivative.

*Specific risk offsetting*

Paragraphs 18 to 21 of Attachment D set out the requirements where an ADI may recognise offsetting.

**ATTACHMENT B**

**Statement of Compatibility with Human Rights**

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

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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 legislative instrument is to revoke *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116) made under Banking (prudential standard) determination No.9 of 2022 and replace it with a new version of APS 116.

APS 116 sets out requirements for an authorised deposit-taking institution (ADI) engaging in activities that give rise to risks associated with potential movements in market prices, to adopt risk management practices and hold regulatory capital that is commensurate with the risks involved.

**Human rights implications**

APRA has assessed the legislative 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 legislative instrument is compatible with human rights.

**Conclusion**

The legislative instrument is compatible with human rights as it does not raise any human rights issues.

1. ‘VaR’ is a measure of the worst expected loss on a portfolio of instruments resulting from market movements over a given time horizon and a pre-defined confidence level. [↑](#footnote-ref-2)
2. 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

contrary to the interests of depositors with the ADI. [↑](#footnote-ref-3)
3. Traded market risk, foreign exchange and commodities capital requirement (TFC capital requirement) - the regulatory capital that an ADI is required to hold against its exposure to market risk in accordance with this Prudential Standard. [↑](#footnote-ref-4)
4. ‘Stressed VaR’, like ‘VaR’ is a technique used to estimate the likelihood of losses in a portfolio based on an analysis of historical price movements and volatilities over a specified observation period. For the ‘Stressed VaR’, however, the model inputs are calibrated to historical data from a one-year observation period of significant market stress relevant to the portfolios being simulated. [↑](#footnote-ref-5)