RESPONSE TO SUBMISSIONS

RESPONSE TO SUBMISSIONS

APS 111 Capital Adequacy: Measurement of Capital

10 May 2021

Disclaimer and Copyright

While APRA endeavours to ensure the quality of this publication, it does not accept any responsibility for the accuracy, completeness or currency of the material included in this publication and will not be liable for any loss or damage arising out of any use of, or reliance on, this publication.

© Australian Prudential Regulation Authority (APRA)

This work is licensed under the Creative Commons Attribution 3.0 Australia Licence   
(CCBY 3.0). This licence allows you to copy, distribute and adapt this work, provided you attribute the work and do not suggest that APRA endorses you or your work. To view a full copy of the terms of this licence, visit <https://creativecommons.org/licenses/by/3.0/au/>

Contents

[Executive summary 4](#_Toc71274556)

[Glossary 6](#_Toc71274557)

[Chapter 1 - Introduction 7](#_Toc71274558)

[First consultation – October 2019 7](#_Toc71274559)

[Second consultation – May 2021 8](#_Toc71274560)

[Implementation timetable 8](#_Toc71274561)

[Chapter 2 - Response to consultation 9](#_Toc71274562)

[2.1 Key policy issues 9](#_Toc71274563)

[2.2 Other policy issues 11](#_Toc71274567)

[2.3 Other clarifications 14](#_Toc71274574)

[Chapter 3 - New proposed revisions 16](#_Toc71274575)

[3.1 Definition of Common Equity Tier 1 capital 16](#_Toc71274576)

[3.2 Other amendments 17](#_Toc71274577)

[Chapter 4 - Consultation 18](#_Toc71274581)

[Request for submissions 18](#_Toc71274582)

[Important disclosure notice – publication of submissions 18](#_Toc71274583)

[Request for cost-benefit analysis information 18](#_Toc71274584)

# Executive summary

An authorised deposit-taking institution’s (ADI's) capital base is the cornerstone of its financial soundness. *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) sets out detailed criteria for measuring an ADI's regulatory capital.

In October 2019, APRA released a Discussion Paper, setting out proposed revisions to APS 111 for consultation.[[1]](#footnote-1) The key proposals focused on:

* reinforcing financial system resilience, through changes to the capital treatment of a parent ADI’s equity investments in their banking and insurance subsidiaries;
* promoting simple and transparent capital issuance, through the removal of the allowance for the use of special purpose vehicles (SPVs) in regulatory capital issuance; and
* clarifying various parts of APS 111, including through providing additional technical information to assist ADIs in issuing capital instruments.

APRA had originally planned to finalise these APS 111 reforms in 2020, but delayed this to allow entities to focus on managing the risks associated with COVID-19. With the recommencement of the policy agenda in 2021, APRA is now seeking to finalise APS 111. This paper summarises the industry submissions to the 2019 consultation, and outlines APRA’s responses to the issues raised. It also sets out some further minor revisions for consultation.

Summary of industry feedback

The changes to the capital treatment of equity investments in subsidiaries was the most material proposed revision to APS 111. APRA’s objective was to reduce the potential risks to Australian depositors from large and leveraged equity investments. The revised APS 111 will, in effect, increase the amount of capital required to support equity investments in large subsidiaries and reduce the amount required for small subsidiaries. While the impact will differ across individual ADIs, this change is not expected to materially increase existing capital requirements for the system in aggregate.

APRA received seven submissions to its proposals. APRA’s response to issues raised is set out in Chapter 2 of this paper. Submissions were supportive of the majority of APRA’s proposed reforms, including the change to the treatment of equity investments in subsidiaries.

Some submissions raised concerns regarding APRA’s proposal to remove the allowance for SPVs in capital issuance. These submissions suggested that the inclusion of SPVs could reduce the additional costs from the Reserve Bank of New Zealand’s (RBNZ’s) proposed changes to its definitions of Additional Tier 1 (AT1) and Tier 2 capital. The implementation of the RBNZ’s proposed reforms will mean that APRA and RBNZ definitions of AT1 and Tier 2 capital will no longer align, requiring ADIs to issue two sets of AT1 and Tier 2 capital instruments for New Zealand subsidiary assets.

APRA does not consider the use of SPVs an appropriate policy response to this issue, as it would increase complexity and reduce transparency in the Australian capital framework. APRA is therefore maintaining its original policy proposal.

However, APRA is engaging with relevant ADIs and the RBNZ on alternative policy responses, which would reduce the need for double issuance of AT1 and Tier 2 capital. Rather than introduce unnecessary complexity into the capital framework, APRA’s preference is to consider how RBNZ capital instruments could be used in supporting the overall loss absorbing capacity of a group. This approach seeks to maintain the integrity of APRA’s capital framework and strengthen cross-border resolution.

Further revisions

As part of this response paper, APRA is also consulting on further proposed revisions that were not included in the October 2019 consultation. Recently, APRA has observed some ADIs attempting to use more complex equity arrangements to raise Common Equity Tier 1 (CET1) capital. The new revisions to APS 111 are set out in Chapter 3, and clarify that CET1 capital is not permitted to have any features that could undermine its role as the highest quality loss absorbing capital.

Next steps

APRA intends to finalise APS 111 in July 2021, and the final revised Prudential Standard will come into force from 1 January 2022. APRA’s response to issues raised in the October 2019 consultation set out in Chapter 2 should be considered final. APRA requests industry feedback on the new proposed revisions, outlined in Chapter 3, by 10 June 2021.This paper and the draft revised Prudential Standard are available on APRA’s website at [www.apra.gov.au](http://www.apra.gov.au).

# Glossary

|  |  |
| --- | --- |
| ADI | Authorised Deposit-taking Institution |
| Additional Tier 1 capital | Capital instruments that provide loss-absorption while the ADI remains a going concern, but do not satisfy all of the criteria for inclusion in CET1 capital. |
| APRA | Australian Prudential Regulation Authority |
| APS 220 | *Prudential Standard APS 220 Credit Risk Management* |
| Basel Committee | Basel Committee on Banking Supervision |
| CET1 capital | Common Equity Tier 1 capital comprises the highest quality components 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. |
| Regulatory capital | Consists of Tier 1 capital and Tier 2 capital. |
| Level 1 | The ADI itself or the Extended Licensed Entity. |
| Level 2 | The consolidation of the ADI and all its subsidiaries other than non-consolidated subsidiaries; or if the ADI is a subsidiary of a non-operating holding company (NOHC), the consolidation of the immediate parent NOHC and all the immediate parent NOHC’s subsidiaries (including any ADIs and their subsidiaries) other than non-consolidated subsidiaries. |
| Tier 1 capital | The sum of the components of CET1 capital, Additional Tier 1 capital, and eligible mutual equity interests (MEIs) issued by a mutually owned ADI (where the MEIs have not already been recognised as CET1 capital). |
| Tier 2 capital | Other components of regulatory capital that, to varying degrees, fall short of the quality of Tier 1 capital but nonetheless contribute to the overall strength of an ADI and its capacity to absorb losses. |
| TLAC standard | Total Loss Absorbing Capacity standard, set out in *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* issued by the Financial Stability Board on 9 November 2015. |

1. Introduction

This chapter summarises APRA’s response to issues raised in the consultation on proposed revisions to APS 111. The consultation period was from October 2019 to January 2020. It also sets out new proposed revisions that were not included in this original consultation, but which would help to clarify aspects of the Prudential Standard.

## First consultation – October 2019

APRA received seven submissions to its consultation on proposed changes to APS 111, of which five were confidential. The two non-confidential submissions have been published on APRA’s website.

APRA has largely maintained the key revisions proposed in the APS 111 consultation. In making amendments to these proposed revisions, APRA has sought to provide greater clarity on its expectations, consistent with industry feedback. The main amendments to the proposals are summarised below. Further detail is provided in Chapter 2.

1. Key amendments to original proposals

|  |  |
| --- | --- |
| Issue | APRA amendment |
| Level 1 treatment of equity investments in banking and insurance subsidiaries | APRA has clarified that, for the purposes of meeting this requirement, CET1 capital should be calculated after all regulatory adjustments excluding any capital deduction resulting from equity investments in banking and insurance subsidiaries exceeding the 10 per cent threshold. This avoids a ‘circular reference’. |
| Funding of capital instruments | For an instrument to be classified as regulatory capital, the issuer cannot directly or indirectly have funded the purchase of the instrument. APRA has clarified that, as an example, indirect funding would include lending to a borrower on a non-recourse basis secured against any capital instruments of the ADI. |
| Minority interest | APRA has clarified that, where a NOHC is head of the Level 2 group and owns other businesses, capital instruments issued by the subsidiary ADI would be subject to the minority interest requirements of APS 111. |
| Documentation and statement of compliance | APRA has clarified that an ADI is not required to provide documentation to APRA for CET1 capital instruments, such as ordinary shares. |

While industry did not support APRA’s proposal to remove the allowance for SPVs in regulatory capital issuance, APRA has maintained its original proposal. The approach suggested by ADIs would not comply with internationally agreed Basel Committee standards, would require complex assessments of instrument eligibility and would introduce new risks from a resolvability perspective. APRA will continue to engage with relevant ADIs and the RBNZ on potential alternative policy responses.

## Second consultation – May 2021

APRA is proposing some new revisions to APS 111 that were not part of the October 2019 consultation. These new revisions make clear that certain prudential requirements historically more relevant to AT1 and Tier 2 capital equally apply to all forms of regulatory capital. Further details are provided in Chapter 3.

## Implementation timetable

Revisions to APS 111 were first consulted on in October 2019, with the intention that the revised standard would be finalised and implemented from 1 January 2021. However, with the onset of COVID-19, APRA delayed these timelines to allow ADIs to prioritise managing risks associated with the pandemic.

APRA expects that the final revised APS 111 will be effective from 1 January 2022. APRA is running a short consultation on some new amendments to APS 111, which are expected to be finalised in July 2021. Feedback on the proposed new revisions should be provided by 10 June 2021.

Ahead of the implementation of the final revised APS 111, ADIs must continue to meet APRA’s interim expectations on the capital treatment of new or additional equity investments in banking and insurance subsidiaries.[[2]](#footnote-2) This was announced in November 2020, to ensure that any new or additional investments in subsidiaries aligns with the intended future state of APS 111.

1. Implementation timeline

|  |  |
| --- | --- |
| Date | Step |
| 10 May 2021 | * Response to October 2019 consultation * New consultation on additional revisions |
| 10 June 2021 | * Consultation on additional revisions closes |
| Mid-July 2021 | * Response to May 2021 consultation * Final revised APS 111 released |
| 1 January 2022 | * Final revised APS 111 in effect |

1. Response to consultation

This chapter provides further detail on APRA’s response to issues raised in the original consultation on proposed revisions to APS 111. The consultation period was from October 2019 to January 2020.

* 1. Key policy issues
     1. ADI equity investments in banking and insurance subsidiaries

In the October 2019 consultation, APRA proposed that an ADI, at Level 1, deduct its equity investments in its banking and insurance subsidiaries from CET1 capital, but only to the extent that the investment in the subsidiary is in excess of 10 per cent of CET1 capital. To the extent the investment is below this 10 per cent threshold, an ADI would risk weight the investment at 250 per cent. This risk weight would be a reduction on the current required level.

Comments received

Some submissions commented that, for the purpose of the 10 per cent threshold, CET1 capital should be calculated after all other regulatory adjustments. Submissions also suggested that capital support provided to banking and insurance subsidiaries should allow a corresponding deduction approach. One submission suggested that the threshold be set annually, based on the closing balance of Level 1 CET1 capital at the end of each financial year.

APRA response

APRA has amended the Prudential Standard to specify that, for the purposes of the 10 per cent threshold, CET1 capital is calculated after all other regulatory adjustments. This avoids a ‘circular reference’ by excluding any capital deduction resulting from equity investments in banking and insurance subsidiaries exceeding the 10 per cent threshold.

APRA does not consider a deduction from AT1 or Tier 2 capital appropriate for the purpose of the threshold deduction, as the threshold is based on CET1 capital and so the deduction would apply to this category of capital.

Capital adequacy must be capable of being calculated at all times. An annual calculation alone would increase the risks of ADIs being undercapitalised through the year.   
APRA therefore does not support the industry suggestion for the 10 per cent threshold to be set annually.

* + 1. TLAC holdings

In its October 2019 consultation, APRA proposed that ADIs deduct their holdings of other banks’ TLAC instruments from Tier 2 capital. APRA’s proposal adopted the Basel Committee’s approach of requiring a Tier 2 capital deduction, but did not adopt a threshold approach whereby the deduction would only apply above a specified level.

For the purpose of this deduction, APRA defined TLAC instruments for other banks (not subject to Australian prudential requirements) with reference to the TLAC standard set out in *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* issued by the Financial Stability Board (FSB) on 9 November 2015.

Comments received

Some submissions noted that by not allowing a threshold deduction approach, Australian ADIs could be at a competitive disadvantage compared to international peers. These ADIs noted that this could hinder the development of the local Tier 2 capital market and suggested that APRA introduce a ‘market facilitation’ exemption for holdings of Tier 2 capital instruments issued by third parties. Some submissions also suggested that the definition of TLAC instruments for other banks required greater clarification.

APRA response

APRA does not support a threshold deduction approach for TLAC holdings. Without full deduction of TLAC holdings across banks, the failure of one bank could lead to a reduction in capital of another bank. Deducting TLAC holdings in full reduces contagion risks in the financial system, which is particularly important given the structure of the domestic banking market.

APRA expects an ADI to use the FSB’s TLAC standard for the purposes of defining holdings of other banks’ TLAC that needs to be deducted. These TLAC holdings would include any facility or instrument recognised or otherwise accepted by regulators, market participants and creditors as a TLAC instrument.[[3]](#footnote-3)

* + 1. Use of special purpose vehicles and stapled security structures

In its October 2019 consultation, APRA proposed to amend APS 111 such that capital instruments involving SPVs and stapled security structures would not be recognised for regulatory capital purposes. APRA’s objective was to ensure that capital instruments are simple, transparent and capable of being readily understood by investors and other market participants.

Comments received

Some submissions did not support APRA’s proposal to remove the use of SPVs from the revised Prudential Standard. These submissions requested that APRA allow complex issuance structures involving SPVs to reduce the additional costs from the RBNZ’s proposed changes to its definitions of AT1 and Tier 2 capital.

ADIs noted that, under the RBNZ’s proposals for implementing their final proposed rules, there will no longer be compatibility between RBNZ and APRA rules on AT1 and Tier 2 capital instruments. In effect, this would require ADIs to issue two sets of AT1 and Tier 2 instruments to fund their New Zealand subsidiaries: one set that meets RBNZ rules and one set that meets APRA rules. Industry suggested that complex issuance structures involving SPVs could be a possible option to minimising the costs of these changes.

APRA response

APRA does not consider it appropriate to allow capital instruments issued through SPVs and stapled security structures to be recognised for regulatory capital purposes. The SPV structure put forward in submissions would not comply with internationally agreed Basel Committee standards, would require complex assessments of instrument eligibility and would introduce new risks from a resolvability perspective. In APRA’s view, these risks could undermine the integrity of APRA’s capital framework.

APRA is working with the RBNZ on policy responses, including assessing how the RBNZ’s proposed new definitions of AT1 and Tier 2 capital could contribute towards the overall loss absorbing capacity of banking groups. Subject to an appropriate strengthening of cross-border resolution arrangements, APRA could take into account the RBNZ-qualifying AT1 and Tier 2 capital when determining the financial resources needed to support the orderly resolution of a major bank. APRA will continue to engage with the major banks on this issue.

* 1. Other policy issues
     1. Capital arbitrage transactions

In its October 2019 consultation, APRA proposed that transactions that have the aim of offsetting capital deductions should not be recognised for capital adequacy purposes. This has been a long-standing APRA expectation, which APRA proposed to formalise in APS 111.

Comments received

Some respondents suggested that APRA not prohibit such transactions. These respondents noted that if such transactions effect a true transfer of risk away from the ADI to a third party, a reduction in required capital should be recognised.

APRA response

In APRA’s view, these transactions can have the effect of overestimating eligible capital, without commensurately reducing the risk in the financial system. Consistent with the Basel Committee’s statement on capital arbitrage transactions, APRA is maintaining its original proposal. This means direct holdings of equity would be deducted whether or not hedged with derivatives. This is the same treatment for indirect equity holdings.

* + 1. Cross default clauses

In its October 2019 consultation, APRA proposed amendments to the existing cross default provisions within APS 111. These revisions sought to formalise APRA’s current approach to assessing the eligibility of capital instruments, which reflects the importance of capital being freely available to support an ADI’s financial position. This could be undermined if an adverse event relating to one capital instrument could trigger a default on other instruments.

Comments received

Some submissions commented that the removal of cross default clauses within capital instruments themselves was unnecessary. These submissions noted that an AT1 capital instrument must not contain any events of default and that Tier 2 capital instruments can only provide for ‘events of default’ on account of default under the terms of the instrument or winding-up of the issuer.

Some submissions requested clarification that cross default provisions as a result of non-payment on a capital instrument would only relate to clauses in an issuer’s other debt funding and capital instruments. These submissions also suggested that the reference in APS 111 to ‘the time for the appeal of the decision has passed’ in relation to irrevocable wind up was not appropriate as it is not desirable to delay the actions of senior creditors once a court action is granted for the holders of Tier 2 capital instruments.

APRA response

APRA considers it appropriate that there be a clear prudential requirement that the terms and conditions of AT1 capital instruments must not contain cross default or event of default clauses.

Clauses specifying the irrevocable winding up of the issuer are permitted for both AT1 and Tier 2 capital instruments. Tier 2 capital instruments must confer no rights on holders to accelerate repayment except in bankruptcy (including wind-up) and liquidation and wind-up must be irrevocable.

APRA considers wind-up to be irrevocable when there has been an effective resolution by shareholders or members for winding-up, or a court order for winding-up has been made and that time for an appeal of the decision has passed. However, APRA does not intend for that time for the passing of an appeal to delay the actions of senior creditors.

* + 1. Funding of capital instruments

In its October 2019 consultation, APRA clarified that, for an instrument to be eligible as regulatory capital, the issuer, any other member of a group to which the issuer belongs, or any related entity, cannot have purchased, or directly or indirectly funded, the purchase of the instrument.

Comments received

One submission requested APRA clarify whether an instrument would be eligible for regulatory capital where: a lending facility provides for recourse against a customer beyond the capital securities lodged as direct collateral for the facility; and a non-recourse facility is secured by capital securities issued by financial institutions other than the ADI or ADIs within the Level 2 group.

APRA response

APRA has clarified in the revised APS 111 that lending to a borrower on a non-recourse basis secured against any capital instruments of the ADI would be considered an indirect holding. APRA has also clarified that full recourse lending to a borrower to purchase a well-diversified and well-collateralised portfolio, which may include capital instruments, is not considered a direct or indirect holding.

* + 1. Minority interest

In its October 2019 consultation, APRA proposed to clarify that APS 111 requirements relating to minority interest do not apply where a NOHC owns 100 per cent of, and its sole direct investment is in, the ADI subsidiary. APRA did not propose any other changes to its requirements in regard to the capital treatment of minority interest.

Comments received

One submission sought clarification as to whether the exemption would apply where the NOHC holds its investment in the ADI via an intermediate holding company which principally acts as a consolidation point for the Level 2 reporting requirements for the 'banking group’.

The same submission suggested that the amount of shares issued to minority interest that can be included in regulatory capital at Level 2 should be based on gross amounts of capital rather than net of amounts of capital. This submission also requested that APRA permit ordinary shares that comply with APS 111 to be included within Level 2 CET1 capital irrespective of the type of subsidiary.

APRA response

Where the ultimate parent is a NOHC, and owns other businesses, they would be subject to the minority interest requirements of APS 111. This reflects that capital raised by the ADI subsidiary in these circumstances may not always be available for general usage by the banking group.

APRA considers it appropriate that the amount of capital issued to minority shareholders that can be included in regulatory capital at Level 2 is based on net amounts of capital rather than gross of amounts of capital, consistent with internationally agreed Basel standards.

APRA is also not changing its long-standing requirement that only ordinary shares that comply with APS 111 requirements can be included within Level 2 CET1 capital if the subsidiary is prudentially regulated. This approach is consistent with internationally agreed Basel Committee standards.

* + 1. Capitalised software expenses

APRA requires ADIs to deduct from regulatory capital various balance sheet items that are likely to have limited value in insolvency, such as intangible assets. APRA’s definition of intangible assets that must be deducted from regulatory capital includes capitalised expenses and capitalised transactions costs. In its October 2019 consultation, APRA did not propose any change to the long-standing APS 111 requirement for ADIs to deduct these intangible assets from regulatory capital.

Comments received

One submission commented that APRA’s current deduction approach to capitalised software expenses provides a disincentive to invest in these types of assets. The submission noted that investment in technology can improve resilience, efficiency and competition. The submission suggested that APRA should consider a threshold deduction approach for capitalised software expenses, whereby the deduction only applies above a specified level.

APRA response

APRA agrees that investment in technology can support an ADI’s long-term resilience. However, APRA does not consider it appropriate to revise its requirement that intangible assets should be deducted from CET1 capital. Intangible assets, such as capitalised software expenses, can automatically lose value as a result of the threat of or actual insolvency of an ADI. APRA does not consider it prudent to include these assets within CET1 capital. A deduction approach to intangible assets provides a prudent reflection of the capital that would be available in stressed conditions.

* + 1. Documentation and statement of compliance

APRA has had a long-standing requirement of entities to provide supervisors with relevant documentation of AT1 and Tier 2 capital instruments where there is a new issuance. In its October 2019 consultation, APRA proposed to extend this requirement to CET1 capital.

Comments received

Some submissions sought clarification whether the proposed amendments required notification to APRA for business-as-usual issuance of ordinary shares, such as dividend reinvestment plans or employee share schemes. Submissions commented that the proposed requirement would be burdensome.

Another submission suggested that APRA’s requirement for CET1 capital documentation should be post issuance. Having regard to the importance of being able to rapidly execute ordinary share issuance transactions, it was suggested that APRA revise its proposal, such that CET1 documentation would be required as soon as practicable after CET1 had been issued.

APRA response

In light of comments regarding increased burden on ADIs, APRA will not require ADIs to provide documentation for new CET1 capital issuance, such as ordinary shares. APRA is instead proposing new eligibility requirements for CET1 instruments, as outlined in Chapter 3. These new proposed revisions clarify that CET1 capital is not permitted to have any features that could undermine its role as the highest quality loss absorbing capital. APRA would expect ADI applicants and new ADIs to provide documentation for CET1 capital issuance as part of the licensing process.

* 1. Other clarifications

Table 3 sets out the response to submissions in regard to other minor clarifications to APS 111. These items, for the most part, do not seek to implement any change in policy, but rather seek to clarify existing requirements in the Prudential Standard.

1. Other clarifications

|  |  |  |  |
| --- | --- | --- | --- |
| Issue | Draft revised APS 111 | Submissions | APRA response |
| Fee income | In its October 2019 consultation, APRA proposed a revision to APS 111 that would affect the calculation of current year and retained earnings. APRA proposed that all fee income, not just upfront fee income, could be included, subject to certain criteria. | Several submissions suggested that APRA retain the narrower focus on upfront fee income. They noted that the proposed change could create a large undertaking by ADIs to review all transactions related to fee income and assess whether they can satisfy the criteria for inclusion in current year earnings. | APRA is maintaining this proposed revision to APS 111. Removal of the specific reference to upfront fee income was to make clear all forms of fee income, whether received or future income, may be included in current year and retained earnings, subject to certain criteria. |
| Amortisation of capital instruments | APS 111 requires a Tier 2 capital instrument to have a minimum original maturity of at least five years. Recognition in regulatory capital is amortised on a straight-line basis as the instrument approaches maturity. In its October 2019 consultation, APRA did not propose any change to this requirement. | Some submissions commented that APRA should allow Tier 2 capital instruments with more than one year to maturity to be recognised in full for loss-absorbing capacity purposes, consistent with the approach under the FSB TLAC term sheet. These submissions suggested that APRA introduce a separate ratio, which recognises the full face value of regulatory capital instruments, including Tier 2 capital, with a maturity greater than one year. | This issue was previously assessed by APRA when developing its approach to increasing loss-absorbing capacity. APRA is maintaining its current approach as to do otherwise introduces unwarranted complexity into the framework. |

1. New proposed revisions

As part of this response paper, APRA is also consulting on new proposed revisions to APS 111 that were not included in the October 2019 consultation.

* 1. Definition of Common Equity Tier 1 capital

Under APS 111, there are a number of aspects of the definitions of AT1 and Tier 2 capital which are more clearly specified than those for CET1 capital. This has reflected the more complex design of AT1 and Tier 2 capital instruments, compared to CET1 capital.

Recently, APRA has observed some ADIs attempting to use more complex equity arrangements to raise CET1 capital in more challenging market conditions. Some of these arrangements would not be permitted within the requirements for lower classes of capital, and would undermine the role of CET1 capital as the highest quality form of capital.

APRA is proposing that appropriately adapted versions of the following requirements for AT1 and Tier 2 instruments also be included in the definition of CET1 capital. This will provide further clarity on APRA’s expectations of CET1 capital. Table 4 outlines the proposed revisions that would apply to all forms of capital.

1. Proposed revisions to CET1 capital requirements

|  |  |
| --- | --- |
| Reference to draft revised APS 111 (October 2019) | Existing requirements for AT1 and Tier 2 that will apply to all tiers of capital, including CET1 |
| Attachment E paragraph 1(h)  Attachment G paragraph 1(h) | Issuers must not assume, or create market expectations, that supervisory approval will be forthcoming for the issuer to redeem, call or purchase an instrument. |
| Attachment E paragraph 1(o)  Attachment G paragraph 1(m) | The instrument has no features that hinder recapitalisation of the issuer, or any other members of the group to which the issuer belongs. This includes features that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified timeframe. |
| Attachment E paragraph 1(q)  Attachment G paragraph 1(o) | The instrument does not contain any terms, covenants or restrictions that could inhibit the ADI’s ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, or restrict APRA’s ability in its role as prudential regulator to resolve any problems encountered by the ADI. |
| Attachment E paragraph 18  Attachment G paragraph 18 | The instrument must not include any ‘repackaging’ arrangements that have the effect of compromising the quality of the capital raised. |

Consistent with these revisions, APRA is also proposing to clarify in paragraph 1(f) of Attachment B and paragraph 1(c) of Attachment I to the draft revised APS 111 (October 2019) that payment of dividends is to be in the form of a cash payment. The proposed wording prohibits features that require an ADI to make payments in kind.

* 1. Other amendments
     1. Conversion or write off of capital instruments

In its October 2019 consultation, APRA proposed changes to paragraph 7 of Attachment F to APS 111 to ensure that only the realisable value resulting from either conversion or write off of AT1 capital instruments (after offsets) may be counted in regulatory capital. APRA is now proposing a corresponding change to paragraph 10 of Attachment H to APS 111, to ensure appropriate alignment with this revised requirement.

* + 1. New APS 220

APRA is also proposing new amendments to APS 111 to ensure appropriate alignment with the introduction of the new *Prudential Standard APS 220 Credit Risk Management* (APS 220). The new APS 220 is expected to be effective no later than 1 January 2022.[[4]](#footnote-4)

APRA is proposing to amend APS 111 to reflect the removal of the General Reserve for Credit Losses requirement from the new APS 220. Under the new proposed approach to APS 111, general provisions held against the relevant exposures or holdings may continue to be included in Tier 2 capital subject to the relevant caps.[[5]](#footnote-5)

For the purposes of deducting from the relevant category of regulatory capital, an ADI may continue to net any specific provisions held against the relevant exposures or holdings, before making the necessary deductions.

* + 1. Existing transition arrangements for capital instruments

APRA is proposing to remove the existing transition arrangements for capital instruments contained in Attachment L of the current APS 111. These arrangements relate to certain non-CET1 and Tier 2 capital instruments issued before 1 January 2013, made redundant with the final revised APS 111 effective from 1 January 2022.

1. Consultation

## Request for submissions

APRA invites written submissions on the proposals set out in Chapter 3 of this Discussion Paper. Written submissions should be sent to [ADIpolicy@apra.gov.au](mailto:ADIpolicy@apra.gov.au) by 10 June 2021 and addressed to:

General Manager

Policy Development

Policy and Advice Division

Australian Prudential Regulation Authority

## Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the Australian Prudential Regulation Authority Act 1998 and will therefore be exempt from production under the FOIA.

## Request for cost-benefit analysis information

APRA requests that all interested stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any increases or decreases to the compliance costs incurred by businesses as a result of APRA’s proposal.

Consistent with the Government’s approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: <https://rbm.obpr.gov.au/home.aspx>.

Respondents are requested to use this methodology to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA’s requirements, not activities that institutions would undertake regardless of regulatory requirements in their ordinary course of business.

1. APRA Discussion paper - *Revisions to APS 111 Capital Adequacy: Measurement of Capital*, October 2019. [↑](#footnote-ref-1)
2. APRA letter to all ADIs: *Interim capital treatment of new or additional equity investments in banking and insurance subsidiaries*, November 2020. [↑](#footnote-ref-2)
3. TLAC holdings do not include CET1, AT1 and Tier 2 capital instruments that qualify as regulatory capital. An ADI must deduct their TLAC holdings that do not otherwise qualify as regulatory capital from their own Tier 2 capital. [↑](#footnote-ref-3)
4. APRA Letter: *Consultation on revisions to the new Prudential Standard APS 220 Credit Risk Management,* December 2020. [↑](#footnote-ref-4)
5. APRA Letter: *Provisions for regulatory purposes and AASB 9 Financial Instruments,* July 2017. [↑](#footnote-ref-5)