

Banking (prudential standard) determination No. 4 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).

On 17 September 2024, APRA made Banking (prudential standard) determination No. 4 of 2024 (the instrument), which determines *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* (APS 117).

The instrument commences on 1 April 2025.

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.

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 117.

Interest Rate Risk in the Banking Book (IRRBB) arises from mismatches in the interest rate sensitivity of an ADI's assets compared with their liabilities. IRRBB is a material risk to ADIs in Australia, given their balance sheets are generally concentrated in housing loans, retail deposits and high-quality liquid assets. ADIs must appropriately manage the underlying risks associated with changing interest rates and their balance sheet positions to ensure they can continue providing banking services to the Australian economy.

APS 117 sets out the requirements that an ADI with approval to use an internal model for IRRBB must meet for regulatory capital purposes.¹ Under APS 117, an ADI must have a framework to manage, measure and monitor IRRBB commensurate with the nature, scale and complexity of the ADI's operations and approval from APRA to use

¹ Internal model ADIs are subject to the Internal Ratings-based Approach to Credit Risk outlined in *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113). The IRB Approach seeks to better align capital with risk by permitting ADIs to use their internal risk models to calculate capital requirements.

an internal model for determining its IRRBB capital charge. Standardised ADIs are not subject to IRRBB regulatory capital under APS 117.²

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 117 follows closely the principles underpinning the BCBS's IRRBB standards, with appropriate Australian adjustments.

The Basel II IRRBB standards impose a regulatory capital requirement for IRRBB through the supervisory review process (Pillar 2) rather than as a minimum capital requirement (Pillar 1). APRA's approach to IRRBB is to adopt a Pillar 1 treatment for internal model ADIs. As such, internal model ADIs have a prescribed IRRBB capital requirement for their IRRBB exposure, increasing transparency, and incentivising them to actively manage their IRRBB (e.g. hedging of interest rate risk either by maturity matching or via derivatives).

2. Purpose and operation of the instrument

The purpose of the instrument is to determine APS 117 to replace the previous version of the standard made under Banking (prudential standard) determination No. 10 of 2012 which will be automatically repealed ('sunsetting') on 1 April 2025 under the *Legislation Act 2003*.

The new APS 117 remakes the previous version of the prudential standard made under Banking (prudential standard) determination No. 10 of 2012 (F2012L02334), without change except for a textual amendment to update a reference to *Prudential Standard APS 001 Definitions* (APS 001) which has been replaced by *Prudential Standard CPS 001 Defined terms* (CPS 001). This amendment does not affect the operation of APS 117 as the reference is included in APS 117 only as a note, and the definitions in APS 001 and CPS 001 apply to APS 117 by operation of APS 001 and CPS 001 respectively.

Details of the new prudential standard

See Attachment A.

Documents incorporated by reference

Under section 10 of the *Acts Interpretation Act 1901*, where an Act refers to another Act, this should be construed as a reference to that other Act as originally enacted, and as amended and re-enacted from time to time. Under section 13 of the *Legislation Act 2003*, the *Acts Interpretation Act 1901* applies to a legislative instrument as if it were an Act.

In reliance on the above provisions, and paragraph 14(1)(a) of the *Legislation Act 2003*, APS 117 incorporates by reference as in force from time to time:

- Acts of Parliament and associated delegated laws; and

² Standardised ADIs are subject to the Standardised Approach to Credit Risk outlined in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112). The Standardised Approach is simple, conservative and caters for a wide range of ADIs. Standardised ADIs are ADIs that have not been approved by APRA to use the IRB Approach.

- 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

Under subsection 11AF(2) of the Act, a prudential standard may provide for APRA to exercise powers and discretions under the standard, including (but not limited to) discretions to approve, impose, adjust or exclude specific prudential requirements in relation to one or more specified ADIs or authorised NOHCs.

APRA's prudential standards include powers that may be exercised by APRA that involve an element of discretion and that may affect the interests of the entities to which the standards apply. These powers include a power to adjust or exclude a provision of the 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, 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 entity 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 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 also a breach of the Act, as section 11AG of the Act provides that ADIs and authorised NOHCs 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 cases 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 (subsection 9A(8) of the Act).

3. Consultation

APRA consulted ADIs and industry extensively on changes to the requirements in APS 117. These changes will take effect on 1 October 2025 in a new version of APS 117 made under Banking (prudential standard) determination No. 5 of 2024.

As part of this consultation, APRA noted in its letter of 8 July 2024 to all ADIs that the existing APS 117 would be automatically repealed (sunsetting) on 1 April 2025. APRA consulted until 9 August 2024 on a proposal to remake the existing version of APS 117 as a transitional measure so that it will continue to apply after 1 April 2025 for a six-month period. This is because there is a genuine need for ongoing regulation before the new version of APS 117 made under Banking (prudential standard) determination No. 5 of 2024 becomes effective. APRA did not receive any submissions or objections from ADIs and industry on the proposal.

4. Impact Analysis

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

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 B to this Explanatory Statement.

ATTACHMENT A

Details of the new prudential standard

The key requirements of APS 117 are set out below.

Authority, application and interpretation

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

Scope

Paragraph 6 sets out the items in the ADI's banking book that the standard applies to.

Definitions

Paragraph 7 is a machinery provision setting out relevant definitions.

Key principles

Paragraph 8 requires an ADI that has IRRBB model approval to have a robust IRRBB framework and a conceptually sound IRRBB measurement system and hold regulatory capital commensurate with its exposure to IRRBB.

Approval process

Paragraphs 9-15 set out the requirements for an ADI that is subject to *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* to apply for internal model approval for IRRBB.

Adoption of the internal model approach

Paragraphs 16-21 set out the requirements for an ADI that has internal model approval for IRRBB to apply the model across all relevant business activities of the ADI. These paragraphs also set out the requirements for partial use of a model on a temporary (a phased roll-out of the model) or permanent basis.

IRRBB management framework

Paragraph 22 requires an ADI with internal model approval for IRRBB to have in place an IRRBB management framework that is sufficiently robust to facilitate quantitative estimates of its IRRBB capital requirement that are sound, relevant and verifiable.

IRRBB measurement system

Paragraphs 23-33 set out the requirements for an IRRBB measurement system, which must be conceptually sound, comprehensive, consistently implemented, transparent and capable of independent review and validation.

These paragraphs also require the IRRBB capital requirement to cover repricing and yield curve risks and, unless APRA approves an exemption, basis risk and optionality risk. An ADI's IRRBB measurement system must also consider the impact that past interest rate movements may have on its future earnings, including embedded gains or losses in banking book items that are not accounted for on a marked-to-market basis.

In addition, an ADI must be able to demonstrate that its IRRBB capital requirement, as determined by its internal model, meets a soundness standard based on a 99 per cent confidence level and a one-year holding period.

An ADI's IRRBB capital requirement must be calculated on at least a quarterly basis to ensure it adequately reflects its risk profile.

Attachment A – Governance and the interest rate risk in the banking book management framework

Attachment A to APS 117 set out the requirements for governance and the IRRBB management framework.

Responsibilities of the Board of directors and senior management

Paragraphs 1-7 of Attachment A to APS 117 set out the responsibilities of the Board of directors and senior management in relation to IRRBB, with the Board responsible for the overall IRRBB profile of the ADI and its IRRBB management framework, and senior management required to have a thorough understanding of the framework, implementing and ensuring its efficient operation.

Sufficient resources

Paragraph 8 of Attachment A to APS 117 requires an ADI to have sufficient resources to ensure that its IRRBB management framework continues to operate effectively.

IRRBB management function

Paragraph 9 of Attachment A to APS 117 requires an ADI to have an independent specialist IRRBB management function.

Documentation of IRRBB framework

Paragraphs 10-12 of Attachment A to APS 117 set out the requirements for an ADI's IRRBB management framework to be clearly documented.

Internal reporting of IRRBB exposures

Paragraphs 13-15 of Attachment A to APS 117 set out the requirements for the internal reporting of IRRBB exposures.

Integration of the IRRBB measurement system

Paragraphs 16-17 of Attachment A to APS 117 set out the requirements for an ADI's IRRBB measurement system to be closely integrated into the ADI's day-to-day risk management processes.

Independent review of the IRRBB management framework and measurement system

Paragraphs 18-19 of Attachment A to APS 117 set out the requirements for the independent review of the IRRBB management framework (both initially, and on an ongoing basis at least once every three years or when a material change is made to the framework).

Attachment B – Quantitative standards for measuring the capital requirement

Attachment B to APS 117 set out the quantitative standards for measuring the IRRBB capital requirement.

IRRBB measurement system track record

Paragraph 1 of Attachment B to APS 117 requires the IRRBB measurement system to have a reasonable track record in measuring IRRBB, before the ADI receives an IRRBB approval.

Data

Paragraphs 2-3 of Attachment B to APS 117 set out the requirements for an ADI to have transparent and verifiable processes for collecting relevant data inputs, and this data must be comprehensive in capturing all material IRRBB exposures.

Interest rate data

Paragraphs 4-9 of Attachment B to APS 117 set out the requirements for the use of interest rate data in determining the IRRBB capital requirement.

Data policies

Paragraph 10 of Attachment B to APS 117 require an ADI to document its IRRBB data management policies and procedures.

Modelling repricing and yield curve risks

Paragraphs 11-18 of Attachment B to APS 117 set out the requirements for determining the IRRBB capital requirement for repricing and yield curve risks, which must also

cover basis and optionality risks, unless an ADI has approval to exclude basis and/or optionality risks.

For the purposes of determining the IRRBB capital requirement for repricing and yield curve risks, an ADI's internal model must measure the maximum potential change in the economic value of the banking book as a consequence of changes in interest rates, for a 99 per cent confidence level and a one-year holding period.

Modelling basis and optionality risks

Paragraphs 19-23 of Attachment B to APS 117 set out the requirements where an ADI does not have APRA approval to exclude basis and/or optionality risks from its IRRBB capital requirement and does not have a risk measurement model for these risks.

IRRBB capital requirement

Paragraphs 24-25 of Attachment B to APS 117 set out the calculation of an ADI's IRRBB capital requirement, as determined by its internal model.

Stress testing

Paragraphs 26-27 of Attachment B to APS 117 set out the requirements for an ADI to have in place a comprehensive and rigorous program of stress testing of its internal model for IRRBB.

Validation

Paragraphs 28-29 of Attachment B to APS 117 set out the requirements for an ADI to have a robust and documented system in place to validate the accuracy and consistency of its internal model for IRRBB.

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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This legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instrument 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 determine *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* (APS 117).

APS 117 sets out requirements that an ADI with approval to use an internal model for determining its interest rate risk in the banking book must meet for regulatory capital purposes, both at the time of initial implementation and on an ongoing basis. 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 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

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