

Banking (prudential standard) determination No. 5 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 17 September 2024, APRA made Banking (prudential standard) determination No. 5 of 2024 (the instrument), which revokes *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* made under Banking (prudential standard) determination No. 4 of 2024 and determines *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (APS 117).

The instrument commences on 1 October 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.

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 BCBS has updated its IRRBB standards as part of the Basel III package of reforms. The updated BCBS standards revise the previous standards, which set out supervisory expectations for banks' identification, measurement, monitoring, and control of IRRBB as well as its supervision. The key enhancements to the previous standards include more extensive guidance on the expectations for a bank's IRRBB management process, as well as key behavioural and modelling assumptions to be considered by banks in their measurement of IRRBB.

Basel III does not significantly change the capital treatment for IRRBB from the previous framework (Basel II), as both frameworks 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, which is long standing, is to adopt a Pillar 1 treatment for internal model ADIs. As such, internal model ADIs have prescribed IRRBB regulatory capital 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).

Recent market conditions have highlighted the importance of ensuring the IRRBB capital charge methodology in APS 117 is appropriately calibrated. This includes addressing unnecessary volatility over time and variation between internal model ADIs in the calculation of their IRRBB capital charge.

The international banking turmoil in 2023 has also highlighted the importance of adequate IRRBB risk management. In March 2023, three US regional banks failed largely due to poor IRRBB risk management that was exposed through changes in the interest rate environment. The lessons learned from the failure of these banks emphasises the importance for all ADIs to effectively manage their interest rate risks and their balance sheet positions.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke the previous version of APS 117 and replace it with a new version.

APS 117 sets out the requirements that an ADI must meet to ensure it prudently manages its IRRBB. Under APS 117, an ADI must have a framework to manage, measure and monitor IRRBB, commensurate with the nature, scale and complexity of its operations and be approved by APRA to use an internal model for determining its IRRBB capital charge.¹ For a standardised ADI, the IRRBB capital charge is zero unless APRA determines otherwise.²

The new APS 117 incorporates changes from the BCBS's IRRBB standards, with appropriate Australian adjustments, reduces unnecessary volatility over time and

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.

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.

variation between internal model ADIs in the calculation of their IRRBB capital charge, and ensures lessons learned from the international banking turmoil in 2023 are addressed.

The new APS 117 adopts a proportional approach across ADIs and principally reaffirms existing risk management requirements for smaller ADIs. The new APS 117 also extends certain non-capital requirements to ADIs that are significant financial institutions (SFIs).³

The new APS 117 also simplifies the IRRBB framework. In line with APRA's approach to better regulation under modernising the prudential architecture, APRA has largely removed duplication of risk management requirements between *Prudential Standard CPS 220 Risk Management* (CPS 220) and APS 117.

Details of the new prudential standard

See Attachment A.

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

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.

³ The SFIs in this context are ADIs or authorised NOHCs with total assets above AUD 20 billion, or ADIs or authorised NOHCs that APRA has determined are SFIs having regard to matters such as complexity in operations or group membership. SFIs can be Internal model ADIs or Standardised ADIs.

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

Since 2018, APRA has undertaken multiple rounds of public consultation in revising APS 117, engaging with a variety of stakeholders, including ADIs, industry bodies, and other regulators.

Submissions from internal model ADIs were broadly supportive of APRA's proposed reforms. Most submissions centred on seeking guidance and clarification on the application and interpretation of certain IRRBB modelling requirements. In response to submissions, APRA has addressed these technical issues, in particular, the treatment of embedded gains and losses and the observation period for the capital charge methodology, to ensure the capital charge is appropriately calibrated.

Submissions from other ADIs were also supportive of APRA's proposal for non-SFIs, which principally reaffirm that all banks are required to manage their material risks, including IRRBB, commensurate with their nature, scale, and complexity.

The consultation process commenced with the release of APRA's February 2018 discussion paper *Revisions to the capital framework for ADIs*. That paper proposed a number of revisions to the capital framework for ADIs to implement the capital requirements for 'unquestionably strong' and to incorporate amendments from the recently finalised Basel III reforms, including proposals for IRRBB which were high-level and directional.

In September 2019, APRA released a response paper and accompanying draft prudential standard to progress the proposed revisions to APS 117, including responding to the key issues relevant to IRRBB raised in submissions to the February 2018 discussion paper, as well as commencing a detailed consultation on other amendments to strengthen the standard.

In November 2022, APRA released a response paper and accompanying draft prudential standard that set out APRA's response to feedback received to its September 2019 consultation and new proposed revisions to APS 117 based on learnings from the recent period of interest rate volatility.

APRA published a response paper and accompanying prudential standard in December 2023 that set out APRA's response to feedback received to its November 2022 consultation and new proposed revisions to APS 117 which were also relevant to smaller ADIs. The December 2023 release considered lessons learned from that year's international banking turmoil.

In finalising the IRRBB reforms, APRA released a response to submissions to the December 2023 consultation in July 2024.

All consultations related to the IRRBB reforms are available on the APRA website.

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 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.

Application of requirements to classes of ADIs

Paragraphs 5 and 6 set out the requirements that do not apply to non-SFIs, and SFIs that do not have IRRBB model approval, unless specifically required by APRA under paragraph 16 of the standard. Paragraph 6 also clarifies that an ADI that has IRRBB model approval must satisfy all of the requirements in the standard.

Commencement, interpretation and definitions

Paragraphs 7 to 11 are machinery provisions relating to the commencement and interpretation of the standard, and relevant definitions used in the standard.

Adjustments and exclusions

Paragraph 12 relies on subsection 11AF(2) of the Act and provides for APRA to adjust or exclude a specific prudential requirement in the standard in relation to one or more specified ADIs or authorised NOHCs.

Previous exercise of discretion

Paragraph 13 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.

Requirements for all ADIs

Paragraphs 14 to 16 set out the requirements for all ADIs to appropriately manage their IRRBB, including the regular reporting of IRRBB exposure to the ADI's Board. These paragraphs also provide for APRA to require an ADI to hold additional regulatory capital and/or in the case of a non-SFI or an SFI that does not have IRRBB model approval, otherwise comply with some or all the requirements of the prudential standard, if the ADI is carrying excessive IRRBB risk and/or not appropriately managing its IRRBB.

Requirements for SFIs

Paragraphs 17 to 20 set out the requirements for an SFI to prudently manage its IRRBB, including the requirement for an ADI that has been granted approval by APRA to use

the internal ratings-based approach to credit risk to hold adequate capital and determine its IRRBB capital at least quarterly.

Internal model approval process

Paragraphs 21 to 27 set out the requirements for the IRRBB model approval process and use of the IRRBB model. They include the powers for APRA to approve material changes to an approved model, to vary or revoke an approval, or impose additional conditions on the approval.

Partial use of internal model

Paragraphs 28 to 33 set out the requirements for partial use of an internal model for IRRBB, being a combination of the approved IRRBB model and an alternative approach approved by APRA.

IRRBB management framework

Paragraphs 34 and 35 set out the requirements for an ADI to develop and maintain its IRRBB management framework.

Responsibilities of the Board of directors

Paragraph 36 require an ADI's Board to regularly review (at least semi-annually) its IRRBB management reports and satisfy itself that IRRBB is appropriately managed.

Responsibilities of senior management

Paragraphs 37 to 42 set out the requirements for senior management to be actively involved and ensure the effective operation of the IRRBB management framework. This includes the requirement for an executive committee, with appropriate representation from across the ADI, which focuses on the management and measurement of IRRBB.

IRRBB risk management

Paragraph 43 requires an ADI to have reporting lines and responsibilities that are independent of the activities that contribute to the ADI's IRRBB profile and must provide access for the risk management function to the executive committee.

New products

Paragraph 44 requires an ADI to assess and understand the IRRBB characteristics and have adequate operational procedures and risk control systems in place before introducing a new product.

IRRBB measurement system

Paragraphs 45 to 49 set out the requirements for ADI's IRRBB measurement system to be conceptually sound, comprehensive, consistently implemented and transparent.

Internal reporting of IRRBB exposures

Paragraphs 50 to 53 set out the requirements for an ADI's internal reporting of IRRBB exposures.

Integration of IRRBB measurement system into day-to-day risk management

Paragraphs 54 to 55 set out the requirements for ADI's IRRBB measurement system to be integrated into the ADI's risk management processes.

Data

Paragraphs 56 to 58 set out the requirements for an ADI to have transparent and verifiable processes for collecting and testing relevant data inputs to its IRRBB measurement system.

Independent review of risk management framework for IRRBB

Paragraphs 59 to 61 set out the requirements for the independent review of the risk management framework in relation to IRRBB.

Regular model testing

Paragraphs 62 to 63 set out the requirements for an ADI that has IRRBB model approval to have a documented process to test the accuracy and consistency of its internal model and assumptions.

Attachment A – Approved IRRBB models

Attachment A to APS 117 set out the requirements for an ADI that has an approved IRRBB model.

Paragraph 2 of Attachment A to APS 117 outlines the IRRBB capital charge calculation. The capital requirement for IRRBB, as determined by the ADI's internal model, must cover the prospective IRRBB capital charges, embedded loss and optionality risk. ADIs are also required to hold any other amount that APRA has notified the ADI must include in its IRRBB capital charge.

Classification of banking book items

Paragraphs 3 to 10 of Attachment A to APS 117 set out the requirements for an ADI to classify banking book items for the purposes of the IRRBB capital calculation.

Interest rate data

Paragraphs 11 to 15 of Attachment A to APS 117 set out the requirements for an ADI to identify and collect data for IRRBB modelling. These paragraphs also require an ADI to use an observation period of eight years for these data.

Calculation of the prospective IRRBB capital charge

Paragraphs 16 to 21 of Attachment A to APS 117 set out the requirements for the prospective IRRBB capital charge.

For a given repricing assumption, an ADI's prospective IRRBB capital charge is the ADI's estimate of the 97.5 per cent expected shortfall of the prospective loss over a one-year holding period.

Repricing Assumptions

Paragraphs 22 to 37 of Attachment A to APS 117 set out the requirements for an ADI's repricing assumptions.

Additional optionality risk

Paragraphs 38 and 39 of Attachment A to APS 117 set out the requirements for an ADI to assess additional optionality risk and where the loss is assessed as material, the ADI must extend its approved IRRBB model to determine a capital charge for those losses, which is the optionality capital charge.

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 revoke *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* and replace it with a new *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (APS 117).

APS 117 sets out requirements for authorised deposit-taking institutions (ADIs) to prudently manage their interest rate risk in the banking book. 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.