



Prudential Practice Guide

APG 120 – Securitisation

January 2008

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About this guide

Prudential Standard APS 120 Securitisation (APS 120) sets out APRA's requirements in relation to the involvement of authorised deposit-taking institutions (ADIs) in securitisation. This prudential practice guide aims to assist ADIs in complying with those requirements and, more generally, to outline prudent practices in relation to securitisation.

Subject to the requirements of APS 120, ADIs have the flexibility to configure their risk management framework for securitisation in the way most suited to achieving their business objectives.

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Scope and definitions

1. APS 120 specifically allows an originating ADI to provide a temporary warehouse facility that qualifies as an eligible facility. This concession is not available for a permanent warehouse facility, though an ADI that is not an originating ADI may provide such a facility, as an eligible facility, if it is provided to a structure that meets the definition of a securitisation and complies with the requirements of paragraphs 1 and 2 of Attachment E to APS 120.
2. The definition of securitisation generally requires multiple tranches in a structure. If a Special Purpose Vehicle (SPV) (other than a warehouse SPV) into which an ADI has originated assets does not meet this requirement, it is not eligible for capital relief under APS 120 and falls under the calculation of regulatory capital for credit risk under *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) or *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) as appropriate. In terms of APS 112 or APS 113, if an ADI is required to consolidate the SPV under accounting standards, the exposures must be included within the Level 2 capital calculation.
3. APS 120 applies to a group on both a Level 1 and Level 2 basis. Therefore, restrictions such as those applying to an originating ADI acquiring securities in an SPV or holding a material beneficial interest in an SPV or trustee are not intended to apply to non-consolidated subsidiaries (e.g. life insurers) acting on behalf of beneficiaries, if such activity occurs in the normal course of business and is in accordance with the subsidiary's investment mandates and/or strategies.
4. However, if an originating ADI actively seeks to use a non-consolidated entity to circumvent the requirements of APS 120, APRA may consider such activity to constitute the provision of implicit support.

Self-assessment

5. APS 120 requires an ADI to undertake a written assessment for each securitisation in which it participates, demonstrating compliance with the requirements of the prudential standard. This applies to all securitisation transactions with an SPV, even when the ADI is merely a facility provider (e.g. a fixed interest rate swap provider) to a securitisation scheme. An ADI may determine the most appropriate format for the assessment. An assessment that considers each relevant requirement under APS 120 individually and clearly sets out references to supporting transaction documentation, policies and procedures, opinions and assessments will assist APRA's understanding of the ADI's compliance process. APRA would expect the assessment to be signed off by senior staff from the ADI's securitisation and legal, compliance or risk management areas.
6. While APRA will obtain regular reporting on securitisation transactions under the ADI reporting framework, APRA will generally not review the assessments as they are made or in advance of issuance. However, a review may be undertaken in specific situations (e.g. if there are prudential concerns with an ADI's self-assessment practices or capacity to undertake self-assessments). APRA will not normally issue letters confirming compliance with APS 120 for particular securitisations, unless they raise particularly unique or novel concerns.
7. APRA envisages that its supervisors will request copies of a sample of self-assessments and the underlying transaction documentation when conducting prudential reviews of ADIs. For originating ADIs, this will generally be in the context of a credit risk review. However, where an institution has a book of market-rate related transactions with SPVs, significant holdings of SPV securities or significant liquidity lines to securitisation schemes, such a review may well occur in the context of a market risk or liquidity management review.

8. APS 120 requires the ADI's involvement with a securitisation to be set out in legal documentation, including legally enforceable contracts and investor documentation. APRA's expectation is that the key requirements relating to the securitisation will be set out in writing and that this written detail will form the basis of the documentation used in the self-assessment. APRA does not believe it is appropriate to rely upon verbal assurances, operational understandings or other undocumented information when an ADI assesses whether it will be in compliance with the requirements of APS 120.
9. APS 120 requires an ADI to consider the economic substance rather than the legal form in determining the capital requirement for a securitisation exposure. APRA expects that each assessment will describe the capital methodology used for the exposures related to that transaction. APRA would not see it as appropriate for an ADI to take a mechanistic legal approach to assessing compliance; rather, staff with a detailed understanding of each specific transaction and its position within the broader securitisation structure would normally be involved.
10. APS 120 provides APRA discretion to require an ADI to seek a legal opinion on any of the separation and other operational requirements for capital relief. APRA would not expect to use these powers routinely. Instances where it might be considered appropriate to require a review include where there are concerns with the quality of the opinion provided in a self-assessment undertaken by the ADI, where unique or novel legal issues are raised by a particular transaction or structure, or where, through its supervisory activities, APRA has concerns that the requirements may not be met in practice.

Financial and operational independence

11. APS 120 requires a securitisation SPV to be financially and operationally independent of the originating ADI. This reflects APRA's view that a securitisation is more than a mere funding mechanism. It is envisaged as an arrangement where the underlying pool of exposures is sold to an SPV, with the intention that the underlying exposures will not return to the originating ADI other than in very limited circumstances.
12. APRA envisages that the SPV would normally provide funding for the full life of the underlying pool without reliance on the originating ADI should there be problems in arranging funding. In addition, APRA envisages that the SPV, consistent with being the owner of the assets, would normally exercise all rights and obligations with respect to the assets on its own behalf without undue regard for the interests of the originator of the assets in the pool. Also, as the independent owner, the SPV's ongoing operations and fortunes should not be tied to those of either the originator or sponsor and it should have an ability to distance itself from the originating ADI.
13. The financial and operational independence of the SPV would normally be reflected in the following features:
 - (a) the SPV could continue to exist and operate as the owner of the pool of assets even if the ADI withdraws (subject to meeting its contractual obligations) its active support for the SPV;
 - (b) a default or a ratings downgrade of the originating ADI would not of itself constitute an event of default on the SPV's securities; and
 - (c) the financial position of the SPV does not depend on the financial standing or rating of the originating ADI.

14. APRA does not expect an SPV, in the ordinary course, to have its own staff or operational infrastructure. An SPV might outsource its operations, subject to normal arm's-length outsourcing arrangements, to the originating ADI or another party. However, the SPV would usually need to have a governance structure and access to sufficient staff, data, operational infrastructure and systems, amongst other factors, to enable it to continue operating if, for whatever reason, an originating ADI is not able to provide a service.
15. Such situations may include where the ADI:
 - (a) decides to withdraw from or wind down all or part of its securitisation activities;
 - (b) decides to exercise a right to terminate facility and service agreements;
 - (c) is subject to a credit rating downgrade;
 - (d) goes into administration or liquidation; or
 - (e) seeks to sell a subsidiary that provides services (e.g. a manager or servicer).
16. A key principle of APS 120 is that an ADI must deal with an SPV and its investors on an arm's-length basis and on market terms and conditions. APRA views this as a two-pronged test under which an ADI would generally be able to demonstrate that:
 - (a) its dealings with an SPV (and its investors) are on the same contractual basis as it would ordinarily use for dealings with an independent 'third-party' SPV (and its investors); and
 - (b) the terms and conditions are broadly equivalent to those under which an independent third party would offer to transact.
17. Where it is not feasible for an independent third party to quote a rate for conducting the transaction (e.g. a basis swap), it would be difficult, in APRA's view, to establish that the deal is on 'an arm's-length basis and on market terms and conditions'.
18. An originating ADI's self-assessment of the compliance of its basis swaps with the requirements of Attachment E to APS 120 (and its approach to valuing such swaps for APRA reporting purposes) will be a particular area of focus in APRA's securitisation reviews. APRA recognises that many basis swaps are inherently non-arm's length. APRA will also seek comfort that a basis swap does not provide credit support, liquidity or other funding to an SPV. Basis swaps also need to be assessed in the context of an ADI's asset-liability and interest-rate risk management policies, including consideration of the need to hedge these exposures.
19. Under APS 120, APRA may require an ADI to deduct the net present value of a derivative transaction from capital where the ADI is or expects to be a net payer for an extended period of time. APRA would not envisage exercising this power where the ADI is already passing the swap revaluation through its profit and loss account for APRA reporting purposes.
20. Attachment E to APS 120 states that a facility or service does not need to specify a fixed termination date provided the ADI has the right, at its absolute discretion, to withdraw from its commitments at any time following a reasonable period of notice.
21. This reinforces the notion of the financial and operational independence of the SPV and is designed to ensure an ADI has the capacity to promptly and effectively distance itself from an SPV should it choose to do so. While APS 120 does not set a fixed time limit, APRA has typically considered 90 days to be a reasonable maximum period of notice.

22. APRA does not consider that making retirement from a facility or service dependent on the appointment of an alternative facility or service provider to be consistent with an ADI being able to withdraw at its absolute discretion. Similarly, the need for an ADI to post collateral for, or the right for an SPV to draw on, a facility in the event of the ADI's retirement would not generally be considered to be consistent with the right of an ADI to withdraw at its absolute discretion. This reflects the fact that, in substance, the ADI retains the economic risk of providing the facility, which is inconsistent with the intention that the risk lapses or ceases at the end of the notice period (other than where a facility has already been drawn in accordance with its terms and conditions and repayment is still outstanding).
23. Attachment E to APS 120 requires that, in specified circumstances and subject to reasonable qualifications, the SPV and/or investors must have the express right to select an alternative party to provide the facility/service.
24. APRA's intention is that an ADI not seek to entrench itself as a facility or service provider to an SPV. Indeed, consistent with an SPV being financially and operationally independent from the originating ADI, the SPV should have an ability to distance itself from the ADI, if the SPV considered it necessary to do so. Where the SPV has a contractual right to exit the arrangement, it should also not be unduly restrained in the choice of an alternative facility or service provider.
25. APRA expects an ADI to undertake its own assessment of the reasonableness of the restrictions that apply to the SPV's ability to seek an alternative facility and service provider. It is expected that an ADI would compare the restrictions both to other securitisation schemes (particularly those involving other ADIs) and also to its non-securitisation dealings. For example, an ADI might compare the restrictions on the SPV seeking an alternative (non-basis swap) derivative provider and the consequences (e.g. break fees) of doing so with the terms in derivatives deals with non-securitisation SPVs and also corporate counterparties.
26. Examples of terms that might not be considered reasonable qualifications include:
 - (a) a requirement that the SPV must not appoint a competitor to the ADI to provide the facility or service; and
 - (b) a requirement that replacement can only occur if a fraud has been perpetrated.

Implicit support

27. APS 120 requires that an ADI must not provide, or knowingly allow the perception to arise that it will provide, support to a securitisation in excess of the ADI's explicit contractual obligations. To do so will be to provide implicit support. In addition, the Board of directors and senior management must put policies and procedures in place that outline how the ADI will ensure it is not providing implicit support for a securitisation.
28. APRA's intent is that each ADI be responsible for ensuring that its transactions are not structured and, equally importantly, its ongoing operations are not carried out, in a way that gives the impression that the ADI supports the securitisation over and above any explicit contractual requirements.
29. APRA envisages that ADIs will develop risk management policies and procedures for their ongoing securitisation activities. These would be designed to provide assurance that an ADI is complying with its contractual obligations and, where it seeks to depart from these, to ensure that there is an appropriate review procedure in place to ensure that the departure could not be seen as giving rise to implicit support (or to otherwise breach requirements of APS 120).
30. Examples of situations that might be seen as providing implicit support include:
 - (a) an originating ADI regularly or systematically refinancing or restructuring lower quality loans in a pool so that they are eligible to be repurchased by the ADI;

- (b) an originating ADI making an indemnity or other payment or accepting a lower fee or reduced charge in lieu of passing on a full increase in a required or threshold rate;
 - (c) an originating ADI purchasing the assets held in an SPV to allow the SPV to avoid making a formal draw on a liquidity facility;
 - (d) an ADI actively seeking to refinance loans it originated into an SPV where the required rate/threshold rate arrangement is above its normal lending rate for similar non-securitised loans or materially above the general market rate for such loans;
 - (e) an ADI entering into a facility to purchase assets from an SPV at above market rates (e.g. via a liquid asset purchase agreement or a market value agreement);
 - (f) an ADI purchasing assets held in an SPV or securities issued by an SPV at above market rates;
 - (g) providing funding to a party to enable it to exercise a clean-up call option (e.g. dated call) that the ADI is not permitted itself to exercise directly;
 - (h) exercising a clean-up call option that acts as a credit enhancement; or
 - (i) providing facilities or services or holding SPV securities via non-consolidated subsidiaries, outside the scope of their normal investment activities, that the ADI (or its Level 2 entities) would not be permitted to provide or hold directly.
32. In determining the appropriate multiple of historical losses, APRA expects an ADI to consider all relevant sources of risk including the type of assets in the pool, downturn or stressed loss rates and historical volatility in losses. Where an ADI relies on a rating agency to determine the size of the first and second loss credit enhancements, it will need to be comfortable that the methodology used adequately reflects any risk of additional losses due to idiosyncratic or specific characteristics of assets in the pool (e.g. special clauses in loan documentation, undertakings made to the borrower when originating loans and unusual concentration of borrowers).
33. The operational requirements for regulatory capital relief set out in Attachment B to APS 120 prohibit the originating ADI from increasing a retained first loss position or credit enhancement. This is not intended to capture a structural arrangement, such as a surplus income arrangement, that is available to cover losses in the scheme. In this situation, the ADI does not provide funding to increase the position, and it cannot recognise for regulatory reporting purposes any income that may arise from its entitlement until it is irrevocably earned.

Repurchase of exposures

34. APS 120 places restrictions on the ability of an originating ADI to enter into a clean-up call. APRA does not intend this restriction to extend to call options entered into by another trust or entity (outside the ADI's Level 2 group), provided the originating ADI does not facilitate that entity's funding of the exercise of the call option. Similarly, APRA does not intend to prevent the call option being entered into by a non-consolidated subsidiary of the originating ADI (e.g. a life insurer) on behalf of its beneficiaries, in the normal course of business and consistent with its investment mandates and/or strategies.

Credit enhancements

31. APRA's expectation is that the size of a first loss credit enhancement will be such that (if it were rated) any second loss credit enhancement supported by the first loss facility would be considered the equivalent of investment grade (i.e. BBB- or above). This is reflected in the provisions of paragraph 10 of Attachment C to APS 120.

35. APS 120 permits an originating ADI to repurchase exposures from an SPV if the repurchase is to grant a further advance to the borrower or similar purpose. This need may arise as the ADI remains the lender of record and retains the customer relationship and so has the legal obligation to the customer. The intent is that this provision facilitates an ADI's ability to respond to customer-initiated transactions that may make the loan ineligible under the SPV's criteria to remain in the pool.
36. Examples of situations that could be seen as similar purposes include:
 - (a) a change in the interest rate basis of the loan (e.g. moving from a floating rate to a fixed rate);
 - (b) a change in the interest rate structure (e.g. from an amortising loan to an interest-only loan);
 - (c) a change in the loan structure (e.g. moving from a full-documentation to a low-documentation loan); and
 - (d) a change in/substitution of the mortgage security.
37. While it is considered appropriate to accommodate these sorts of arrangements, APRA does not wish to see the provisions used in such a way as to routinely or systematically transfer doubtful or lower quality exposures in the pool back to the originating ADI or to accelerate the winding down of the pool (which would likely amount to implicit support).
38. In particular, APRA would not expect an originating ADI to make a general offer to refinance (prior to scheduled maturity) its customers' loans held in a pool. Rather, APRA would expect customers to initiate the transactions in the normal course of meeting their banking requirements.

Funding facilities

39. APS 120 requires that a funding facility provided by an originating ADI (other than a temporary funding facility provided during the establishment phase of a securitisation) does not fund a disproportionate amount of the pool of the SPV at any time during the life of the securitisation. Consistent with facilities being on an arm's-length basis and market terms and conditions, APRA expects that an originating ADI's assessment of 'disproportionate' would take into account factors such as:
 - (a) the nature of the facility;
 - (b) its intended use;
 - (c) its intended run-off/resizing over the life of the pool; and
 - (d) the normal level of similar facilities in other ADIs' securitisation schemes.
40. For example, where an originating ADI is providing a redraw funding facility to a scheme (which is not being assessed as a revolving credit securitisation under APS 120), APRA would expect a relatively low limit to be in place and the limit to reduce in amount as the pool reduces.
41. In general, consistent with the threshold for purchasing securities issued by an SPV, APRA expects that the aggregate amount of funding facilities would not exceed 20 per cent of the value of the pool at a point in time. APRA would, however, expect that an ADI in its self-assessment would assess what amount would be considered disproportionate in light of each individual facility, rather than adopting a simple numeric cap.

Spread accounts and similar surplus income arrangements

42. Attachment B to APS 120 sets out requirements for spread accounts and similar arrangements. In assessing whether an arrangement falls under this provision, APRA envisages that an ADI would look at the economic substance of the arrangement rather than the legal form.
43. Examples of other arrangements that might fall under these provisions could include residual capital units and subordinated bonus fees for servicing. The latter depends on the normal or base fee being set on a full market rate basis and the base or underlying agreement meeting all of the relevant requirements of APS 120 in its own right.

Liquidity facilities

44. There are two broad types of liquidity facilities used in the Australian market: those that provide short-term funding to cover timing mismatches between the receipt of payments from the underlying pool and the payments due to note holders; and those for asset-backed commercial paper (ABCP) programs. The latter are standby facilities that provide funding to the SPV should it be unable to refinance or roll-over maturing short term paper in the market. The former facility will generally be sized as a relatively small proportion of the pool, while the latter will often cover virtually the whole pool.
45. The provision in paragraph 2(f) of Attachment E to APS 120 would generally only be relevant to a liquidity facility that relates to the refinancing or rollover of securities issued by the SPV. This reflects the fact that in a liquidity facility that only covers timing mismatches, there are generally no securities that are being funded.
46. APRA does not intend paragraph 2(d) of Attachment E to APS 120 to prevent an ADI providing a timing mismatch liquidity facility to a non-ABCP securitisation in the ordinary course. This is provided that the draws are neither significant in size in relation to the pool nor structural (providing medium to long-term funding) in nature.
47. APRA considers structural borrowings to be in the nature of funding rather than liquidity facilities. In particular APRA believes it may be difficult, given their cash flow characteristics, to structure a liquidity facility to a reverse mortgage securitisation to meet the requirements for a facility under APS 120.
48. An unrated liquidity facility that does not qualify as an eligible liquidity facility will be subject to a capital deduction of the committed amount under the standardised approach, unless it is the most senior exposure in a securitisation or, for an ABCP securitisation, it is in a second loss or better position.
49. For an ADI with approval to use an internal ratings-based (IRB) approach to calculating regulatory capital for credit risk, an unrated liquidity facility that is not an eligible facility will be subject to capital deduction of the committed amount if none of the ratings-based approach, internal assessment approach nor supervisory formula can be applied.

Disclosure

50. APS 120 requires an originating ADI to ensure clear and prominent disclosures of certain matters in documents inviting investment in a securitisation. Best practice would be to include the disclosures as a stand-alone item on the inside front cover of the document as well as obtain, where this is possible given the trading environment, a signed acknowledgement from investors that they have read and understood the disclosures (which would be repeated in close proximity to the signature).

Shared collateral and trust back arrangements

51. Trust back arrangements are a specific feature in some securitisation arrangements that enable an ADI to maintain a security interest for retained exposures where the underlying collateral/ security has been equitably assigned to the SPV (and is generally held by a security trustee).
52. In many instances, the arrangement operates such that the ADI does not share in the cash flows (including those arising from enforcement action) generated by the secured facilities provided to the customer on a *pro rata* basis or better. In this case APRA would consider, for the purposes of Attachment C to APS 112, the ADI to be a second mortgagee. An ADI subject to APS 112 is, therefore, only eligible to assign a risk-weight of less than 100 per cent to its retained exposures if they meet the requirements of paragraph 13 of Attachment C to APS 112.

Transitional provisions

53. APS 120 provides for transitional arrangements for an existing securitisation exposure where the ADI is unable to comply with the applicable operational requirements of the standard. If an ADI is in breach of APS 120 at the end of a relevant transitional period, APRA may use its discretion to determine an additional capital requirement appropriate to the risks raised by the particular breach.
54. Where an ADI cannot readily or cost effectively modify existing documentation to achieve compliance with the relevant operational requirement, APRA may consider accepting an agreement or undertaking from the ADI on its actions if this would effectively address the risks raised by non-compliance. For example, if an originating ADI has entered into a date-based call option in an existing securitisation, APRA might consider an undertaking from the ADI not to seek to exercise the option unless at least 90 per cent of the value of the pool has been amortised as mitigating the breach.

Mapping of ratings grades for Standard & Poor's, Moody's and Fitch

Standardised approach

55. Attachment C to APS 120 provides that, where an ADI uses the standardised approach to calculating regulatory capital for credit risk, the risk-weighted asset amount of a securitisation exposure must be calculated by multiplying the exposure value or, in the case of an off-balance sheet exposure, the credit equivalent amount of the exposure, by the risk-weight associated with the exposure's credit rating grade.

56. Table 1 in Attachment C to APS 120 sets out long-term credit rating grades and corresponding risk-weights. For the purposes of this table, where the external credit assessment institution (ECAI) is Standard & Poor's, Moody's or Fitch, APRA would normally expect ratings to be mapped as shown in Table 1 below.

Table 1: Recognised long-term ratings and equivalent credit rating grades			
Credit rating grade	Standard & Poor's Corporation	Moody's Investor Services	Fitch Ratings
1	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
2	A+	A1	A+
	A	A2	A
	A-	A3	A-
3	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
4	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
5	B+	B1	B+
	B	B2	B
	B-	B3	B-
6	CCC+	Caa1	CCC+
	CCC	Caa2	CCC
	CCC-	Caa3	CCC-
	CC	Ca	CC
	C	C	C
	D		D

57. Table 2 in Attachment C to APS 120 sets out short-term credit rating grades and corresponding risk-weights. For the purposes of this table, where the ECAI is Standard & Poor's, Moody's or Fitch, APRA would normally expect ratings to be mapped as shown in Table 2 below.

Table 2: Recognised short-term ratings and equivalent credit rating grades			
Credit rating grade	Standard & Poor's Corporation	Moody's Investor Services	Fitch Ratings
1	A-1	P-1	F-1
2	A-2	P-2	F-2
3	A-3	P-3	F-3
4	Others	Others	Others

IRB approach

58. Attachment D to APS 120 provides that, for an ADI that has been approved to use an IRB approach, the risk-weighted asset amount of a securitisation exposure must be calculated by multiplying the exposure value or, in the case of an off-balance sheet exposure, the credit equivalent amount, by the relevant risk-weight. The relevant risk weight depends on, *inter alia*, the credit rating grade assigned to the securitisation exposure by an ECAI, or an inferred rating.

59. Table 3 in Attachment D to APS 120 sets out long-term credit rating grades and corresponding risk-weights. For the purposes of this table, where the ECAI is Standard & Poor's, Moody's or Fitch, APRA would normally expect ratings to be mapped as shown in Table 3 below.

Credit rating grade	Standard & Poor's Corporation	Moody's Investor Services	Fitch Ratings
1	AAA	Aaa	AAA
	AA+	Aa1	AA+
2	AA	Aa2	AA
	AA-	Aa3	AA-
3	A+	A1	A+
4	A	A2	A
5	A-	A3	A-
6	BBB+	Baa1	BBB+
7	BBB	Baa2	BBB
8	BBB-	Baa3	BBB-
9	BB+	Ba1	BB+
10	BB	Ba2	BB
11	BB-	Ba3	BB-
12	Below BB- and unrated	Below Ba3 and unrated	Below BB- and unrated

60. Table 4 in Attachment D to APS 120 sets out short-term credit rating grades and corresponding risk-weights. For the purposes of this table, where the ECAI is Standard & Poor's, Moody's or Fitch, APRA would normally expect ratings to be mapped as shown in Table 4 below.

Table 4: Recognised short-term ratings and equivalent credit rating grades			
Credit rating grade	Standard & Poor's Corporation	Moody's Investor Services	Fitch Ratings
1	A-1	P-1	F-1
2	A-2	P-2	F-2
3	A-3	P-3	F-3
4	Others	Others	Others



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