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Prudential Standard APS 112

Capital Adequacy: Standardised Approach to Credit Risk

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that an authorised deposit-taking institution using the standardised approach to credit risk applies a uniform approach to the measurement of its on-balance sheet assets and off-balance sheet credit exposures for regulatory capital purposes.

The key requirements of this Prudential Standard are:

- on-balance sheet assets and off-balance sheet exposures must be risk-weighted for regulatory capital purposes. Risk-weights are based on external rating grades or fixed weights broadly aligned with the likelihood of counterparty default; and
- the credit risk regulatory capital requirement for on-balance sheet assets and off-balance sheet exposures may be reduced where the asset or exposure is secured against eligible collateral or where the authorised deposit-taking institution has obtained direct, irrevocable and unconditional credit protection from a guarantee or a credit derivative from an eligible guarantor or protection provider.

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1. This Prudential Standard is made under paragraphs 11AF(1)(c) and 11AF(1AA) (b) of the *Banking Act 1959* (**Banking Act**).

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**) with the exception of:
 - (a) foreign ADIs within the meaning of subsection 5(1) of the Banking Act; and
 - (b) those ADIs that have approval from APRA to use an internal ratings-based approach to credit risk under *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*.
3. A reference to an ADI (or other ADIs) in this Prudential Standard shall be taken as a reference to:
 - (a) an ADI (or ADIs) on a **Level 1** basis; and
 - (b) an ADI (or ADIs) on a consolidated banking group **Level 2** basis.

Further details on how this Prudential Standard applies on a Level 1 and Level 2 basis are set out in draft¹ *Prudential Standard APS 110 Capital Adequacy*.

4. An ADI to which this Prudential Standard applies must comply with the standardised approach to credit risk on a Level 1 basis and, where the ADI is a member of a consolidated banking group, on a Level 2 basis.

Risk-weighting approach

5. An ADI's Board of Directors (**Board**) and senior management must ensure that systems are in place to assess the credit risk of an ADI's operations, to allocate adequate capital to cover that risk and to ensure that the pricing of assets and exposures reflects the risk undertaken.
6. An ADI must, in accordance with this Prudential Standard, risk-weight its on-balance sheet assets and off-balance sheet exposures, including both market-related and non-market-related exposures, according to certain risk classes.
7. In determining risk-weights to be used for on-balance sheet assets and off-balance sheet exposures, an ADI must refer to the requirements in Attachments A, B, C, D, E, F and G to this Prudential Standard.
8. An ADI must convert its off-balance sheet exposures which give rise to credit risk into on-balance sheet equivalents using the credit conversion factors in

¹ All references to draft prudential standards in this Prudential Standard are references to the versions that are intended to take effect from 1 January 2008.

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Attachments G, H and I to this Prudential Standard prior to allocating the relevant risk-weight.

Eligible residential mortgages

9. An ADI may, for risk-weighting purposes, treat loans and claims secured by eligible residential mortgages in accordance with Attachment E subject to the requirements of this Prudential Standard.

Collateral, guarantees and credit derivatives

10. Although the primary determinant of the risk-weight of a particular on-balance sheet asset or off-balance sheet exposure is generally the nature and external rating (if any) of the asset or exposure, or underlying counterparty, an ADI may recognise certain **eligible collateral** and guarantees and credit derivatives that provide for direct, irrevocable and unconditional recourse to the guarantor or protection provider, to reduce the risk-weighted amount of its on-balance sheet asset or off-balance sheet exposure (refer to the Attachments J, K, L, M, N, O, and P to this Prudential Standard).
11. An ADI, under the **simple approach to credit risk mitigation**, may assign a lower risk-weight, based on the collateral rather than the counterparty to the asset or exposure, for an on-balance sheet asset or off-balance sheet exposure secured against eligible collateral.
12. Alternatively, for those assets or exposures secured by eligible collateral, an ADI may choose to adopt the **comprehensive approach to credit risk mitigation**. Under the comprehensive approach to credit risk mitigation, the exposure remains to the counterparty but the ADI may reduce the amount of the exposure for risk-weighting purposes according to the value of collateral. Potential price movements must be provided for through adjustments to both the value of the exposure and the collateral. The exposure amount after risk mitigation must be risk-weighted according to the risk-weight of the counterparty.
13. Under both the simple and comprehensive approaches to credit risk mitigation, where a claim on a counterparty is covered by an **eligible guarantee** or a credit derivative that can be used for credit risk mitigation purposes subject to the provisions of this Prudential Standard being met, the covered portion of the claim may be weighted according to the risk-weight appropriate to the guarantor or credit derivative protection provider. The uncovered portion of the claim must be weighted according to the risk-weight applicable to the original counterparty (refer to Attachments J, K, L, M, N, O, and P to this Prudential Standard).

Netting

14. An ADI may use netting to reduce the risk-weighted amount of the ADI's credit exposure to a counterparty when calculating the ADI's regulatory capital

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requirements provided the ADI meets the requirements of Attachment Q to this Prudential Standard.

DRAFT**Attachment A****Standardised approach to credit risk: Risk-weighted on-balance sheet assets**

1. This Attachment in conjunction with Attachments B, C, D, E and F sets out the specific requirements on how to calculate the risk-weighted amount of an ADI's on-balance sheet assets under the standardised approach to credit risk.
2. The risk-weighting process used for measuring an ADI's on-balance sheet assets covers all on-balance sheet assets held by the ADI, except the following specifically excluded items:
 - (a) those assets or investments that are required to be deducted from Tier 1 and/or Tier 2 capital under draft² *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*;
 - (b) debt and equity securities held in the trading book (the associated risk-weighted exposures are determined in accordance with *Prudential Standard APS 116 Capital Adequacy: Market Risk (APS 116)*);
 - (c) on-balance sheet positions in commodities (the associated risk-weighted exposures are determined in accordance with APS 116);
 - (d) on-balance sheet unrealised gains on market-related off-balance sheet transactions (which are to be included in the calculation of an ADI's total risk-weighted off-balance sheet credit exposures – refer to Attachments G, H and I); and
 - (e) securitisation exposures, which are subject to the requirements of *Prudential Standard APS 120 Securitisation (APS 120)*.

Risk-weighted assets

3. An ADI's total risk-weighted on-balance sheet assets (for the purpose of assessing its credit risk regulatory capital requirement) equal the sum of the risk-weighted amounts of each on-balance sheet asset it holds.
4. The risk-weighted amount of an on-balance sheet asset is determined by multiplying its current book value (including accrued interest or revaluations, and net of any specific provision or associated depreciation) by the relevant risk-weight determined in accordance with Attachments B, C, D, E, and F.
5. Where an on-balance sheet claim on a counterparty is secured against qualifying collateral, a qualifying guarantee or credit derivative, an ADI may use the credit risk mitigation techniques detailed in Attachments J, K, L, M, N, O, and P to reduce the risk-weighted amount of the ADI's credit exposure to a counterparty when calculating the ADI's regulatory capital requirements.

² Refer to footnote 1.

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6. An ADI must consult APRA if in doubt as to how to determine the risk-weighted amount of a particular on-balance sheet asset.

DRAFT**Attachment B****Risk-weights for on-balance sheet assets**

Claim	External rating grade³	Risk-weight
Class I - Cash items		
1. Notes and coins.		0%
2. All Australian dollar balances and other Australian dollar claims on the Reserve Bank of Australia.		0%
3. Gold bullion held in the ADI's own vaults or on an allocated basis by another party to the extent that it is backed by gold bullion liabilities.		0%
(Gold bullion held on an unallocated basis by another party, though backed by gold liabilities, is weighted as a claim on the counterparty unless a lower risk-weight is approved in writing by APRA.)		
4. Cash items in the process of collection (e.g. cheques, drafts and other items drawn on other ADIs or overseas banks ⁴ that are payable immediately upon presentation and that are in the process of collection).		20%
Class II – Claims on Australian and foreign governments		
5. All Australian dollar claims held in the banking book ⁵ on the Australian Government.		0%

³ These external rating grades refer to long-term ratings issued by ratings agencies. Refer to Attachments C and D for the recognition criteria of these ratings for the purposes of this Attachment and, where relevant, the use of specific short-term ratings for exposures to ADIs, overseas banks and corporate counterparties.

⁴ All references to overseas banks in the Attachments to this Prudential Standard include financial institutions in a country which (i) have the power to accept deposits in the regular course of business; (ii) are supervised by the supervisor of banks; and (iii) are subject to the same prudential requirements as banks (including capital adequacy).

⁵ For the purposes of this Attachment, all claims on these entities which are held in the trading book are treated in accordance with APS 116.

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Claim	External rating grade	Risk-weight
6. Claims held in the banking book on international central governments and state or regional governments, State or Territory Governments in Australia (including State or Territory central borrowing authorities) and foreign currency claims on the Australian Government (refer to Attachments C and D).	1	0%
	2	20%
	3	50%
	4,5	100%
	6	150%
	Unrated ⁶	100%
7. Claims held in the banking book on local governments and non-commercial public sector entities in Australia and overseas (refer to Attachments C and D).	1	20%
	2	50%
	3,4,5	100%
	6	150%
	Unrated ⁷	100%
	Class III – Claims on central banks, international banking agencies, regional development banks, ADIs and overseas banks	
8. Claims held in the banking book on international central banks and foreign currency claims on the Reserve Bank of Australia (refer to Attachments C and D).	1	0%
	2	20%
	3	50%
	4,5	100%
	6	150%
	Unrated ⁸	100%
9. Claims held in the banking book on international banking agencies and multilateral regional development banks (refer to Attachments C and D). ⁹	1	20%
	2,3	50%
	4,5	100%
	6	150%
	Unrated ¹⁰	50%

⁶ For the purposes of this Attachment, external rating grades that are “Unrated” refers to a claim that must be assessed as unrated for risk-weighting purposes under paragraph 11 of Attachment C.

⁷ Refer to footnote 6.

⁸ Refer to footnote 6.

⁹ A zero per cent risk-weight will apply to the following highly rated institutions and banks: the International Monetary Fund, the Bank for International Settlements, the European Central Bank, the International Bank for Reconstruction and Development, the International Finance Corporation, the Asian Development Bank, the African Development Bank, the European Bank for Reconstructions and Development, the Inter-American Development Bank, the European Investment Bank, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank and the Council of Europe Development Bank.

¹⁰ Refer to footnote 6.

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Claim	External rating grade	Risk-weight
10. Claims (other than equity) ¹¹ held in the banking book on ADIs and overseas banks, being claims with an original maturity of three months or less (refer to Attachments C and D).	1,2,3	20%
	4,5	50%
	6	150%
	Unrated ¹²	20%
11. Claims (other than equity) ¹³ held in the banking book on ADIs and overseas banks with an original maturity of more than three months (refer to Attachments C and D).	1	20%
	2,3	50%
	4,5	100%
	6	150%
	Unrated ¹⁴	50%

Class IV – Claims secured against eligible residential mortgages

12. Refer to detailed risk-weighting schedule in Attachment E.

Class V – Unsettled and failed transactions

13. Refer to Attachment F.

¹¹ Refer to paragraphs 20 and 21 of this Attachment for the regulatory capital treatment of these equity exposures.

¹² Refer to footnote 6. For the purposes of this Attachment, exposures to an unrated ADI or overseas bank cannot receive a risk-weight lower than that applied to exposures to its central government.

¹³ Refer to footnote 11

¹⁴ Refer to footnote 12.

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Claim	External rating grade	Risk- weight
Class VI – Past due claims		
14. The unsecured portion of any claim ¹⁵ (other than loans and claims secured against eligible residential mortgages as per paragraph 12 of this Attachment) that is past due for more than 90 days and/or impaired: ¹⁶		
(a) where specific provisions are less than 20 per cent of the outstanding amount of the past due claim or impaired asset; or		150%
(b) where specific provisions are no less than 20 per cent of the outstanding amount of the past due claim or impaired asset.		100%
15. Loans and claims secured against eligible residential mortgages that are past due for more than 90 days and/or impaired: ¹⁷		
(a) where there is no acceptable LMI ¹⁸ cover in place;		100%
(b) where there is acceptable LMI ¹⁹ cover in place, to the extent that the total of loans and claims covered by a single insurer that are past due for more than 90 days and/or impaired ²⁰ do not exceed the ADI's large exposure limit; ²¹ or		Original risk-weights
(c) where there is acceptable LMI ²² cover in place, to the extent that the total of loans and claims covered by a single insurer that are past due for more than 90 days and/or impaired ²³ exceed the ADI's large exposure limit. ²⁴		100%

¹⁵ For the purpose of defining the secured portion of past due claims, qualifying collateral and guarantees will be the same as those recognised for credit risk mitigation purposes as per Attachments J, K, L, M, N, O and P.

¹⁶ Refer to *Prudential Standard APS 220 Credit Quality (APS 220)* for the definition of "90 days past due" and "impaired" for the purposes of this Attachment.

¹⁷ Refer to footnote 16.

¹⁸ Acceptable LMI has the same meaning for the purpose of this Attachment as it has in Attachment E.

¹⁹ Refer to footnote 18.

²⁰ Refer to footnote 16.

²¹ Refer to *Prudential Standard APS 221 Large Exposures*.

²² Refer to footnote 18.

²³ Refer to footnote 16.

²⁴ Refer to footnote 21.

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Claim	External rating grade	Risk-weight
Class VII– Other assets and claims		
16. Claims (other than equity) ²⁵ held in the banking book on Australian and international corporate counterparties (including insurance and securities companies) and commercial public sector entities (refer to Attachments C and D).	1	20%
	2	50%
	3,4	100%
	5,6	150%
	Unrated ²⁷	100%
<p>Alternatively, if an ADI has obtained approval in writing from APRA, it may risk-weight all claims (other than equity) held on the banking book on Australian and international corporate counterparties (including insurance and securities companies) and commercial public sector entities at 100 per cent.²⁶ If an ADI has obtained approval in writing to use a 100 per cent risk-weight for these claims, it must do so in a consistent manner and not use any external ratings for any of these claims.</p>		
17. All claims (other than equity) ²⁸ in the banking book on private sector counterparties (other than ADIs, overseas banks and corporate counterparties).		100%
<p>This includes, for example, personal loans, leasing finance and bill acceptances drawn by private sector counterparties, credit cards, overdrafts, small business facilities and all other property loans (including loans secured against commercial property).</p>		
18. Investments in premises, plant and equipment and all other fixed assets.		100%
19. Claims on all fixed assets under operating leases.		100%

²⁵ Refer to footnote 11.

²⁶ In order to obtain approval, an ADI will be required to satisfy APRA that the regulatory capital requirement resulting from a 100 per cent risk-weight for these claims is not materially less than the regulatory capital requirement which would apply if external ratings were used or the cost of using external ratings for these exposures outweighs the benefits.

²⁷ Refer to footnote 6.

²⁸ Refer to footnote 11.

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Claim	External rating grade	Risk-weight
20. Equities that form part of the ADI's "equity investment portfolio" and any equity investments that are not deducted from capital ²⁹ and are traded in the indices listed in APS 116.		300%
21. Equities that form part of the ADI's "equity investment portfolio" and any equity investments that are not deducted from capital and that are not traded in the indices listed in APS 116.		400%
22. All other assets and claims not specified elsewhere.		100%

²⁹ Refer to APS 111.

DRAFT**Attachment C****Use of short- term and long-term external ratings****External credit assessment ratings**

1. An ADI must only use the solicited ratings³⁰ of APRA-approved external credit assessment institutions (**ECAIs**) for determining risk-weights of counterparties and exposures (refer to Attachment D).
2. For both risk-weighting and risk management purposes, an ADI must use its chosen ECAIs and the ratings of these institutions consistently for each type of claim.
3. An ADI must not use external ratings for one entity within a corporate group to determine the risk-weight for other (unrated) entities within the same group. If the rated entity has guaranteed the unrated entity's exposure to the ADI, the guarantee may be recognised for risk-weighting purposes if the criteria for recognition in Attachment M are satisfied.
4. An ADI may only use an ECAI rating that takes into account all amounts, both principal and interest, owed to it.

Multiple assessments

5. In the case where a counterparty has multiple general issuer ratings or where an issue has multiple specific-issue ratings from different ECAIs that are used by the ADI for capital adequacy purposes, the following principles must be observed in determining the rating to be used for risk-weighting purposes:
 - (a) if there is only one rating for a particular claim, that rating must be used to determine the risk-weight of the claim;
 - (b) if there are two ratings which correspond to different risk-weights, the higher risk-weight must be used to determine the risk-weight of the claim;
or
 - (c) if there are three or more ratings that correspond to different risk-weights, the ratings corresponding to the two lowest risk-weights must be applied for risk-weighting purposes, and the higher of those two risk-weights must be used to determine the risk-weight of the claim.

³⁰ A solicited rating is a rating that has been initiated and paid for by the issuer or rated counterparty or a commercial associate of the issuer or rated counterparty.

DRAFT**Issuer and issue ratings***Claims on issues with an issue-specific rating*

6. If an ADI invests in a particular issue that has an issue-specific rating, the risk-weight of the claim must be based on the issue-specific rating.

Unrated claims where a risk-weight can be inferred from an issue-specific rating of another debt issued by the counterparty

7. If:
- (a) an ADI's claim on a counterparty does not have an issue-specific rating;
 - (b) the unrated claim ranks pari passu or is senior in all respects to an issued debt of the same counterparty that does have an issue-specific rating; and
 - (c) the risk-weight applicable to that rated claim is lower than the risk-weight applicable to unrated claims of the relevant kind

the ADI may treat the unrated claim as having the issue-specific rating. If paragraphs (a) and (b) are satisfied but the risk-weight inferred from the issue-specific rating is higher than the risk-weight for unrated claims of the relevant kind, the higher risk-weight must be used.

8. If:
- (a) an ADI's claim on a counterparty does not have an issue-specific rating; and
 - (b) the unrated claim is subordinated to an issued debt of the same counterparty that does have an issue-specific rating

the unrated claim must receive the risk-weight for unrated claims of the relevant kind, unless that produces a lower risk-weight than that which would apply to the issue-specific rating. In the latter case the ADI's claim must receive the issue-specific rating of the rated claim.

Unrated claims where a rating can be inferred from the counterparty's general issuer rating

9. If:
- (a) an ADI has a senior claim on a counterparty and that claim does not have an issue-specific rating;
 - (b) the counterparty has a general issuer rating;³¹ and

³¹ In the case of claims on international state or regional governments, State or Territory governments in Australia, local governments and non-commercial public sector entities detailed in paragraphs 6 and 7 of Attachment B, where the counterparty does not have a general issuer

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- (c) the risk-weighting associated with the counterparty's general issuer rating is lower than the risk-weight for unrated claims of the relevant kind

the ADI may treat the unrated senior claim as having the general issuer rating. However, if the risk-weight associated with the counterparty's general issuer rating is higher than the risk-weight for unrated claims of the relevant kind, the higher risk-weight must be used.

- 10. Unrated subordinated claims against a counterparty must be assessed as unrated for risk-weighting purposes unless that produces a lower risk-weight than that which would apply to a senior claim.

Other unrated claims

- 11. If:
 - (a) an ADI's claim does not have an issue-specific rating;
 - (b) a risk-weight for the unrated claim cannot be inferred from an issue-specific rating of an issued debt of the counterparty; and
 - (c) the counterparty does not have a general issuer rating

the ADI's claim must be assessed as unrated for risk-weighting purposes.

Domestic and foreign currency items

- 12. An ADI must not use a rating that refers to a claim denominated in a particular currency to derive the risk-weight for another claim on the same counterparty if that claim is denominated in another currency.

Short-term ratings

- 13. Short-term ratings may only be used for short-term claims against ADIs, overseas banks and corporate counterparties.
- 14. If there is an issue-specific short-term rating in respect of a claim, it must be used to assess the risk-weighted amount of the claim. Subject to paragraphs 15 to 20 of this Attachment, a short-term issue-specific rating cannot be used to risk-weight any other claim.

rating, the rating of the sovereign of domicile of the counterparty may be substituted to determine the risk-weight of the ADI's claim. In the case of claims detailed in paragraph 8 of Attachment B, this means the rating of the sovereign of domicile of the institution.

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15. The following risk-weights will apply to issue-specific short-term ratings:

External rating grade (short term claims on corporates, ADIs and overseas banks) ³²	1	2	3	4
Risk-weight	20%	50%	100%	150%

16. Notwithstanding paragraph 14 of this Attachment, where the counterparty has a short-term claim that attracts a 50 per cent risk-weight, unrated short-term claims on the same counterparty cannot be risk-weighted less than 100 per cent.
17. Notwithstanding paragraph 14 of this Attachment, where the counterparty has a short-term claim that attracts a risk-weight of 150 per cent, all unrated claims (short-term and long-term) on the same counterparty must be risk-weighted at not less than 150 per cent.

Short-term claims on ADIs and overseas banks

18. The general preferential treatment for short-term claims of the kind referred to in paragraph 10 of Attachment B applies to all claims on ADIs and overseas banks that have an original maturity of up to three months where there is no issue-specific short-term claim rating.
19. Where there is an issue-specific short-term rating on a claim held by an ADI, and that rating corresponds to a lower or identical risk-weight than that derived from the general treatment in paragraph 10 of Attachment B, the issue-specific short-term rating may be used for the specific claim.
20. Where there is an issue-specific rating for a short-term claim on an ADI or overseas bank and that rating corresponds to a higher risk-weight than that which would be applied by paragraph 10 of Attachment B, the general short-term preferential treatment cannot be used for any short-term claim on the counterparty. All unrated short-term claims on that counterparty would receive the same risk-weight as that implied by the specific short-term assessment.

³² Refer to Attachment D.

DRAFT**Attachment D****External rating grades for rated counterparties and exposures**

1. For the purpose of risk-weighting claims on rated counterparties and exposures, APRA recognises the ratings of Standard & Poor's Corporation, Moody's Investor Services and Fitch Ratings. Based on the long-run default experience of these ECAIs, the ratings of these agencies correspond to external rating grades which align with risk-weights as set out in Attachment B.
2. APRA may recognise, at its discretion, other ECAIs upon application by the ECAI or an ADI.
3. Each external rating grade in the left hand column of the following table corresponds to the long-term ratings in the same row in the other columns.

External 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-

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External rating grade	Standard & Poor's Corporation	Moody's Investor Services	Fitch Ratings
6	CCC+	Caa1	CCC+
	CCC	Caa2	CCC
	CCC-	Caa3	CCC-
	CC	Ca	CC
	C	C	C
	D		D

4. Each external rating grade in the left hand column of the following table corresponds to the short-term ratings in the same row in the other columns.

External 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

DRAFT**Attachment E****Eligible residential mortgages**

1. For capital adequacy purposes, a loan for housing or other purposes which is fully secured by registered mortgage over a residential property (whether or not the property is owned by the borrower) may be assigned a risk-weight of less than 100 per cent subject to satisfying the criteria set out in this Attachment.
2. The risk-weights for eligible residential mortgages do not apply to mortgage-backed securities. The capital treatment for those exposures is detailed in APS 120.

Lending criteria

3. An ADI must at all times have unequivocal enforcement rights over a mortgaged residential property (including a power of sale and a right to possession) in the event of default by the borrower.
4. An ADI must have procedures in place to assess the ability of borrowers to meet repayment obligations. The assessment criteria must be documented as part of the ADI's lending/credit policy and procedures manual.
5. An ADI must have in place verification procedures to substantiate critical application data provided by the borrower. Such procedures must be documented in the ADI's lending/credit policy and procedures manual. Essentially, these should include procedures for verifying income documentation sufficient for the ADI to make an assessment of the repayment capacity of the borrower. All material income sources and employment details of the borrower must be assessed by the ADI prior to loan approval, and documented as part of the loan origination and approval process.
6. An ADI that outsources any part of its credit assessment process to a third party (such as mortgage originators and brokers) must ensure that the arrangement complies with *Prudential Standard APS 231 Outsourcing*.³³ The ADI should undertake due diligence on all third parties it uses to make any lending decisions or that undertake assessments of borrower information on its behalf. There should be a formal agreement in place with the third party that specifies the criteria that are to be used in approving the loan. The ADI must have audit and monitoring procedures in place to ensure that its lending criteria are applied at all times by the third party.
7. If an ADI accepts the purchase price, or other means of valuation, as being an indication of the value of the residential property offered as security for a loan in lieu of a formal valuation, the ADI must detail the rationale used to justify this use in its lending/credit policy and procedures manual. The manual must

³³ Where an ADI uses a third party for loan administration functions only, and does not outsource any part of the credit assessment process to the third party, the responsibility for ensuring that the lending criteria are met remains with the ADI.

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include clear guidelines that detail the circumstances under which the purchase price or other means of valuation are acceptable to the ADI as an indication of the property value as well as circumstances where a formal valuation of the property is required (refer to paragraph 8 of this Attachment).

8. Where an ADI requires a formal valuation of each residential property offered as security for a loan, the valuation must be carried out by an independent accredited valuer nominated by the ADI. The ADI's lending/credit policy and procedures manual should document procedures for determining whether a formal valuation of one or more existing residential security properties is required when the specific property or properties are to be used in support of a new loan. The ADI's lending/credit policy and procedures manual should also document the procedures to be followed for revaluing properties where the ADI becomes aware of a material change in the value of properties in an area or region.
9. Any residential property offered as security for a loan must be readily marketable. In assessing the marketability of such property, an ADI may take into account factors such as whether the property is within residential or rural residential zoning or other evidence which can demonstrate that the property is likely to be readily sold (such as recent price and turnover data for similar properties in the same area or region). This would normally exclude remote rural residential properties or residential properties that could only be sold at a significant discount. An ADI must detail its policy for determining the marketability of a residential property offered as security in its lending/credit policy and procedures manual.
10. Where security is provided by third parties (i.e. parties other than the specific borrower), an ADI should ensure that those parties understand fully the consequences of default on the loans and their legal obligations. Loans covered by security provided by third parties, where the relevant mortgage is unenforceable under the Consumer Credit Code, are risk-weighted at 100 per cent in the absence of any eligible collateral and guarantees.
11. Subject to satisfying other criteria set out in this Attachment, loans for purposes other than housing must be fully secured against mortgages over existing residential property to receive a risk-weight less than 100 per cent. Loans, for whatever purpose, secured against speculative residential construction or property development (e.g. multiple dwellings such as blocks of units) do not qualify for a risk-weight less than 100 per cent.
12. Loans that are fully secured by residential properties but fail to meet any of the criteria set out in paragraphs 4, 5, 7, 8, and 9 of this Attachment are referred to as **non-standard loans**. Where a loan is classified as non-standard because it does not meet the criteria set out in paragraph 4 or 5 of this Attachment, such loans may be reclassified as standard loans provided the borrower has substantially met its contractual loan repayments to the ADI continuously over the previous 36 months. Criteria defining when contractual loan repayments are substantially met must be set out in the ADI's lending/credit policy and procedures manual.

DRAFT**Loan-to-valuation ratio and mortgage insurance**

13. The applicable risk-weight differs for standard and non-standard eligible residential mortgages, and for uninsured and insured mortgages when insured to at least 40 per cent of the amount of the mortgage by an acceptable lenders mortgage insurer (**LMI**) (refer to paragraphs 20 and 21 of this Attachment). Risk-weights are determined according to the ratio of the outstanding amount (refer to paragraph 14 of this Attachment) of the loan to the value at origination (or based on a subsequent formal revaluation by an independent accredited valuer, where relevant) of the mortgaged residential property securing the loan (**LVR**) as in the following table:

LVR	Standard eligible mortgages		Non-standard eligible mortgages	
	Risk-weight (no mortgage insurance)	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI)	Risk-weight (no mortgage insurance)	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI)
(%)	(%)	(%)	(%)	(%)
0 – 60	35	35	50	35
60.01 – 80	35	35	75	50
80.01 – 90	50	35	100	75
90.01 - 100	75	50	100	75
> 100.01	100	75	100	100

14. For the purposes of paragraph 13 of this Attachment, the “outstanding amount” of a loan is calculated as the balance of all claims on the borrower that are secured against the mortgaged residential property. This includes accrued interest and fees, as well as the gross value of any undrawn limits on commitments (which cannot be cancelled at any time without notice), e.g. any redraw amount available on the loan or undrawn limit on a revolving credit facility. The outstanding amount under an “all moneys” mortgage should include all loans and other exposures to the borrower that are effectively secured against the mortgage.
15. If a loan is also secured against a second mortgage, the outstanding amount of the loan must be calculated as the sum of all claims on the borrower secured by both the first and second mortgages over the same residential property for the purpose of assessing the LVR.
16. For the purposes of paragraph 13 of this Attachment, the value of the mortgaged residential property at origination may be determined in accordance with paragraphs 7 or 8 of this Attachment.
17. If a loan is secured by more than one property, the LVR must be determined on the basis of the outstanding amount of all claims on the borrower that are

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secured against the mortgaged residential properties to the aggregate value of the mortgaged residential properties.

18. An ADI may, in risk-weighting a loan secured by an eligible residential mortgage, make allowance for eligible collateral and guarantees. The recognition of eligible collateral and guarantees is detailed in Attachments J, K, L, M, N and O and depends upon the ADI's choice between the simple and comprehensive approaches to credit risk mitigation. A mortgage offset or other similar account may only be netted off against the outstanding amount of the loan where the arrangement meets the requirements for eligible cash collateral as set out in paragraphs 11 and 12 of Attachment K.

Second mortgages

19. To qualify for a risk-weight less than 100 per cent, any loans secured by a second mortgage over residential property must, in addition to the requirements in this Attachment, satisfy the following conditions:
 - (a) the first mortgage must not be able to be extended without being subordinated to the second mortgage;
 - (b) an ADI must obtain a written consent of the first mortgagee for the second mortgage and confirm the maximum outstanding amount of the loan secured by the first mortgage (including maximum drawdown or limit of facility) for LVR purposes; and
 - (c) an ADI must ensure that its interest as second mortgagee is noted on the title.

Mortgage insurance

20. For the purposes of paragraph 13 of this Attachment, an LMI policy must cover for all losses up to at least 40 per cent of the original loan amount.
21. To qualify as a mortgage insured by an acceptable LMI:
 - (a) for the purposes of Level 1 regulatory capital requirements, the LMI must be regulated by APRA; and
 - (b) for the purposes of Level 2 regulatory capital requirements, in the case of overseas subsidiaries of Australian ADI's, APRA will accept the host supervisors' requirements on what constitutes an acceptable LMI in those jurisdictions.

DRAFT**Attachment F****Unsettled and failed transactions**

1. The risk-weights for transactions with a **normal settlement period**³⁴ that are undertaken through a delivery-versus-payment (**DvP**)^{35,36} system and remain unsettled after their due delivery dates are detailed in the following table.³⁷ The amount that must be multiplied by the relevant risk-weight is the **positive current exposure amount**. The positive current exposure amount is the difference between the agreed settlement price of the transaction and the current market price of the transaction where this would result in a loss to the ADI.

Number of business days after due settlement date	Risk-weight (%)
5 to 15	100
16 to 30	625
31 to 45	937.5
46 or more	1,250

2. An ADI must hold regulatory capital against a non-DvP transaction³⁸ with a normal settlement period³⁹ where:
 - (a) it has paid for debt instruments, equities, foreign currencies or commodities before receiving them or it has delivered debt instruments, equities, foreign currencies or commodities before receiving payment for them; and
 - (b) in the case of a cross-border transaction, one day or more has elapsed since it made that payment or delivery.
3. The regulatory capital requirement for a non-DvP transaction referred to in paragraph 2 of this Attachment is as follows:
 - a) from the business day after the ADI has made its payment or delivery for up to and including four business days after the counterparty payment or delivery is due, the ADI must treat the transaction as an exposure; and

³⁴ For the purpose of this Prudential Standard, normal settlement period means a contractual settlement period that is equal to or less than the market standard for the instrument underlying the transaction and in any case, less than 5 business days.

³⁵ This would include payment-versus-payment transactions, i.e. foreign exchange transactions in which each counterparty is obligated to make a final transfer of one or more currencies only where the other counterparty has made a final transfer of one or more currencies.

³⁶ Transactions settled through a DvP system provide for the simultaneous exchange of securities or commodities for cash and expose an ADI to the risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at current market price.

³⁷ This excludes all repurchase and reverse-repurchase agreements as well as securities lending and borrowing transactions.

³⁸ A non-DvP transaction exposes the ADI to the risk of loss on the full amount of cash paid or deliverables delivered.

³⁹ Refer footnote 34.

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- b) from five business days after the ADI has made its payment or delivery until extinction of the transaction, the ADI must deduct 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital of the value transferred plus the positive current exposure.
- 4. Where a non-DvP transaction is required to be treated as an exposure (refer to paragraph 3(a) of this Attachment) an ADI may apply the relevant risk-weights as detailed in Attachments A, B, C, D and E to this Prudential Standard. Alternatively, where exposures are not material, the ADI may apply a 100 per cent risk-weight provided that all such exposures are risk-weighted consistently.
- 5. In the case of a system-wide failure of a settlement or clearing system, the failure of a counterparty to settle a trade need not be deemed a default for the purpose of this Prudential Standard.

DRAFT**Attachment G****General requirements for credit risk-weighting off-balance sheet credit exposures**

1. This Attachment, in conjunction with Attachments H and I, sets out the requirements for calculating the risk-weighted amount of an ADI's off-balance sheet exposures under the standardised approach to credit risk.
2. The risk-weighting process used for measuring an ADI's off-balance sheet credit exposures applies to all of the ADI's off-balance sheet business, including both market-related and non-market-related transactions.

Risk-weighted amount

3. An ADI's total risk-weighted off-balance sheet credit exposure is calculated as the sum of the risk-weighted amount of all its market-related and non-market-related transactions.
4. The risk-weighted amount of an off-balance sheet transaction that gives rise to credit exposure must generally be calculated by the following two-step process:
 - (a) first, the notional amount of the transaction must be converted into an on-balance sheet equivalent (i.e. credit equivalent amount) by multiplying the amount by a specified credit conversion factor; and
 - (b) second, the resulting credit equivalent amount must be multiplied by the risk-weight (refer to Attachments A, B, C, D, E and F) applicable to the counterparty or type of exposure. Where the transaction is secured by eligible collateral, guarantee or credit derivative, the credit risk mitigation techniques detailed in Attachments J, K, L, M, N, O and P may be used to reduce the regulatory capital requirement of the exposure.
5. An ADI must consult APRA if in doubt about the risk-weighted amount of a particular off-balance sheet transaction.

Non-market-related off-balance sheet transactions

6. The credit equivalent amount in relation to a non-market-related off-balance sheet transaction referred to in Attachment H (these transactions are broadly categorised into direct credit substitutes, trade and performance-related contingent items and other commitments) is determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor specified in the Attachment.
7. If the non-market-related off-balance sheet transaction is an undrawn or partially undrawn facility, the amount of undrawn commitment that must be included in calculating an ADI's off-balance sheet non-market-related credit exposures is the maximum unused portion of the commitment available to be drawn during the remaining period to maturity. Any drawn portion of a

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commitment must be included as part of an ADI's on-balance sheet credit exposure.

8. For irrevocable commitments to provide off-balance sheet facilities, the original maturity must be measured from the commencement of the commitment up until the time the associated facility expires. For example, an irrevocable commitment, with an original maturity of six months, to provide finance with a nine-month term is deemed to have an original maturity of 15 months.
9. Irrevocable commitments to provide off-balance sheet facilities should be assigned the lower of the two applicable credit conversion factors. For example, an irrevocable commitment with an original maturity of six months to provide a guarantee in support of a counterparty for a period of nine months, attracts the 50 per cent credit conversion factor applicable to the commitment.
10. All commitments must be included in the capital calculation regardless of whether or not they contain "material adverse change" clauses or any other provisions which are intended to relieve an ADI of its obligations under certain conditions.
11. For any non-market-related off-balance sheet transaction that gives rise to credit risk, but which is not specifically identified in Attachment H, an ADI must consult APRA on the appropriate credit conversion factor to be used for calculating the credit equivalent amount of that particular transaction for capital adequacy purposes. APRA may, in writing, determine an appropriate credit conversion factor for the transaction (having regard to the risk entailed by the transaction and the credit conversion factors applicable to similar transactions).

Market-related off-balance sheet transactions

12. In calculating an ADI's risk-weighted off-balance sheet credit exposures arising from market-related transactions for capital adequacy purposes, an ADI must include all market-related transactions held in the banking and trading books which give rise to off-balance sheet credit risk.
13. The credit risk of an off-balance sheet market-related transaction is the cost to an ADI of replacing the cash flow specified by the contract in the event of counterparty default. This will depend, among other things, on the maturity of the contract and on the volatility of rates underlying the instrument.
14. Market-related transactions include, but are not limited to, the following:
 - (a) interest rate contracts - these include single currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and any other instruments of a similar nature;
 - (b) foreign exchange contracts (including contracts involving gold) - these include cross-currency swaps (including cross-currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options purchased, hedge contracts and any other instruments of a similar nature;

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- (c) equity contracts - these include swaps, forwards, purchased options and similar derivative contracts based on individual equities or equity indices;
 - (d) precious metal contracts (other than gold) - these include swaps, forwards, purchased options and similar derivative contracts based on precious metals such as silver, platinum and palladium;
 - (e) other commodity contracts (other than precious metals) - these include swaps, forwards, purchased options and similar derivative contracts based on energy contracts, agricultural contracts, base metals (such as aluminium, copper and zinc) and any other non-precious metal commodity contracts; and
 - (f) other market-related contracts - these include any contracts covering other items which give rise to credit risk.
15. An ADI should seek clarification from APRA if it is unclear as to the category in which a particular market-related transaction should be included.
16. Exemption from capital weighting is permitted for:
- (a) foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and
 - (b) instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.
17. An ADI should not generally enter into contracts at off-market prices. This includes historical rate rollovers on foreign exchange contracts. In the case of historical rate rollovers, the ADI must have a policy framework in place around the granting and monitoring of historical rate rollovers. This policy framework must be agreed with APRA. Transactions outside of the APRA-agreed framework must be discussed with APRA. APRA will determine, in writing, the capital (and other prudential) treatment of these transactions.
18. An ADI may, for capital adequacy purposes, net off-balance sheet claims and obligations arising from market-related contracts across both the banking and trading books, arising from contracts with a single counterparty, where the relevant obligations are covered by eligible bilateral netting agreements (refer to Attachment Q).
19. The credit equivalent amount of an off-balance sheet market-related transaction, whether held in the banking or trading book, must be determined using the current exposure (mark-to-market) method.

Current exposure method

20. The credit equivalent amount of a market-related contract not covered by an eligible bilateral netting agreement and calculated using the current exposure method must be calculated as the sum of current credit exposure and potential future credit exposure (the add-on) of these contracts (refer to Attachment Q for

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calculation of credit equivalent amount of market-related contracts covered by eligible bilateral netting agreements).

21. Current credit exposure is defined as the sum of the positive mark-to-market value (or replacement cost) of these contracts.
22. Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts (regardless of whether the contract has a zero, positive or negative mark-to-market value) by the relevant credit conversion factor specified in Attachment I according to the nature and residual maturity of the instrument.
23. The notional or nominal principal amount, or value, of a contract is the reference amount used to calculate payment streams between counterparties to a contract.
24. Potential future credit exposure must be based on effective rather than apparent notional amounts. In the event that the stated notional amount of a contract is leveraged or enhanced by the structure of the transaction, an ADI must use the effective notional amount when calculating potential future credit exposure. For example, a stated notional amount of one million dollars with payments based on an internal rate of two times the bank bill rate would have an effective notional amount of two million dollars.
25. For contracts that are structured to settle outstanding exposures following specified payment dates where the terms are reset such that the mark-to-market value of the contract is zero on these specified dates, the residual maturity must be set equal to the time until the next reset date. In the case of interest rate contracts with these features with a remaining maturity of more than one year, the credit conversion factor to be applied is subject to a floor of 0.5 per cent even if there are reset dates of a shorter maturity.
26. For contracts with multiple exchanges of principal, the credit conversion factors are to be multiplied by the number of remaining payments (i.e. exchanges of principal) still to be made under the contract.
27. Contracts which do not fall within one of the five categories listed in Attachment I should be treated in the same way as “other commodities contracts”.
28. No potential future credit exposure is calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts must be evaluated solely on the basis of their mark-to-market value.
29. An ADI may use all instruments included in the trading book as eligible collateral for securities financing transactions included in the trading book. Instruments which would otherwise not be treated as eligible collateral for the purposes of this prudential standard are subject to a haircut at the level applicable to non-main index equities listed on recognised exchanges. Where an ADI uses the own-estimates approach to haircutting, haircuts must be

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calculated for each individual security that counts as eligible collateral in the trading book but not the banking book.

30. An ADI must calculate the counterparty credit risk regulatory capital requirement for single name credit default swaps in the trading book using the following potential future exposure credit conversion factors:⁴⁰

	Protection buyer	Protection seller⁴¹
“qualifying” ⁴² reference obligation	5%	5%
“non-qualifying” reference obligation	10%	10%

31. An ADI must calculate the counterparty credit risk regulatory capital requirement for single name total-rate-of-return swaps in the trading book using the following potential future exposure credit conversion factors:⁴³

	Protection buyer	Protection seller
“qualifying” ⁴⁴ reference obligation	5%	5%
“non-qualifying” reference obligation	10%	10%

32. An ADI, in calculating the counterparty credit risk regulatory capital requirement for an nth-to default credit derivative transaction (such as a first-to-default transaction), must use the add-on determined by the nth lowest credit quality underlying in the basket. For example, for a first-to-default transaction, if there are any non-qualifying items in the basket, the non-qualifying reference obligation add-on must be used.

⁴⁰ There is no difference depending on residual maturity.

⁴¹ The protection seller of a credit default swap shall only be subject to the add-on factor where it is subject to closeout upon the insolvency of the protection buyer while the underlying is still solvent. The add-on should then be capped to the amount of unpaid premiums.

⁴² The definition of “qualifying” is the same as for the “qualifying” category for the treatment of specific risk under the standardised measurement method in APS 116.

⁴³ There is no difference depending on residual maturity.

⁴⁴ Refer to footnote 42.

DRAFT**Attachment H****Credit conversion factors for non-market-related off-balance sheet transactions**

Nature of transaction	Credit conversion factor
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Direct credit substitutes

Any irrevocable off-balance sheet obligations which carry the same credit risk as a direct extension of credit, such as an undertaking to make a payment to a third party in the event that a counterparty fails to meet a financial obligation or an undertaking to a counterparty to acquire a potential claim on another party in the event of default by that party, constitutes a direct credit substitute (i.e. the risk of loss depends on the creditworthiness of the counterparty or the party against whom a potential claim is acquired).

100%

These include potential credit exposures arising from the issue of guarantees and credit derivatives (selling credit protection), confirmation of letters of credit, issue of standby letters of credit serving as financial guarantees for loans, securities and any other financial liabilities, and bills endorsed under bill endorsement lines (but which are not accepted by, or have the prior endorsement of, another ADI).

Performance-related contingencies

Contingent liabilities which involve an irrevocable obligation to pay a third party in the event that a counterparty fails to fulfil or perform a contractual non-monetary obligation, such as delivery of goods by a specified date etc (i.e. the risk of loss depends on a future event which need not necessarily be related to the creditworthiness of the counterparty involved).

50%

These include issue of performance bonds, bid bonds, warranties, indemnities, and standby letters of credit in relation to a non-monetary obligation of a counterparty under a particular transaction.

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Nature of transaction	Credit conversion factor
Trade-related contingencies	
Contingent liabilities arising from trade-related obligations which are secured against an underlying shipment of goods for both issuing and confirming ADIs.	20%
These include documentary letters of credit issued, acceptances on trade bills, shipping guarantees issued and any other trade-related contingencies.	
Lending of securities or posting of securities as collateral	
The lending or posting of securities as collateral by ADIs. These include repurchase/reverse repurchase agreements and securities lending/borrowing transactions. ⁴⁵	100%
Assets sold with recourse	
These include any asset sales (to the extent that such assets are not included on-balance sheet) by an ADI where the holder of the asset is entitled to “put” the asset back to the ADI within an agreed period or under certain prescribed circumstances, e.g. deterioration in the value or credit quality of the asset concerned. ⁴⁶	100%

⁴⁵ These exposures may be treated as collateralised transactions as per the credit risk mitigation techniques detailed in Attachments J, K, L, M, N, O and P. Where an ADI, acting as an agent, arranges a repurchase/reverse repurchase or securities lending/borrowing transaction between a customer and a third party and provides a guarantee to the customer that the third party will perform on its obligations, the risk to the ADI is the same as if the ADI had entered into the transaction as principal. In such circumstances, the ADI will be required to calculate regulatory capital requirements as if it, itself, was the principal.

⁴⁶ For the purposes of this Attachment, these transactions are risk-weighted according to the type of assets or the issuer of securities (as appropriate) and not according to the counterparty with whom the transaction is made, where the credit risk associated with the underlying asset which has been sold (temporarily with recourse) or purchased, remains with the ADI.

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Nature of transaction	Credit conversion factor
Forward asset purchases	
<p>These include commitments to purchase at a specified future date and on pre-arranged terms, a loan, security or other asset from another party, including written put options on specified assets with the character of a credit enhancement.⁴⁷</p> <p>Where an ADI purchasing the asset has an unequivocal right to substitute cash settlement in place of accepting delivery of the asset and the price on settlement is calculated with reference to a general market price indicator (and not to the financial condition of any specific entity), the purchase may be treated as a market-related off-balance sheet transaction.</p> <p>Written put options expressed in terms of market rates for currencies or financial instruments bearing no credit risk are excluded from risk assets.</p>	100%
Partly paid shares and securities	
<p>These include any amounts owing on the uncalled portion of partly paid shares and securities held by an ADI which represent commitments with certain drawdown by the issuer at a future date.⁴⁸</p>	100%
Placements of forward deposits	
<p>This relates to any agreement between an ADI and another party whereby the ADI will place a deposit at an agreed rate of interest with that party at a predetermined future date.</p>	100%
Note issuance and underwriting facilities	
<p>This involves arrangements whereby a borrower may drawdown funds up to a prescribed limit over a predefined period by making repeated note issues to the market and where, should the issue prove unable to be placed in the market, the unplaced amount is to be taken up or funds made available by an ADI being committed as an underwriter of the facility.</p>	50%

⁴⁷ Refer to footnote 46.

⁴⁸ Refer to footnote 46.

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Nature of transaction	Credit conversion factor
Other commitments	
(a) Commitments with certain drawdown.	100%
(b) Commitments (e.g. undrawn formal standby facilities and credit lines) with an original maturity of:	
(i) one year or less.	20%
(ii) over one year.	50%
(c) Commitments that can be unconditionally cancelled at any time without notice (e.g. undrawn overdraft and credit card facilities providing that any outstanding unused balance is subject to review at least annually) or effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness.	0%
(d) Irrevocable standby commitments provided under APRA's approved industry support arrangements.	0%

DRAFT**Attachment I****Credit conversion factors for market-related off-balance sheet transactions****Current exposure method**

Residual maturity	Interest rate contracts	Foreign exchange and gold contracts	Equity contracts	Precious metal contracts (other than gold)	Other commodity contracts (other than precious metals)
1 year or less	0.0%	1.0%	6.0%	7.0%	10.0%
> 1 year to 5 years	0.5%	5.0%	8.0%	7.0%	12.0%
> 5 years	1.5%	7.5%	10.0%	8.0%	15.0%

DRAFT**Attachment J****General principles for use of the simple approach to credit risk mitigation**

1. This Attachment in conjunction with Attachments K, L and M set out the simple approach to credit risk mitigation. This approach may be used by an ADI using the standardised approach to credit risk to determine the appropriate risk-weight for an exposure secured by eligible collateral or eligible guarantee.
2. No additional recognition of credit risk mitigation will apply for capital adequacy purposes on claims where the risk-weight is mapped from an issue-specific rating and that rating already reflects credit risk mitigation (refer to Attachment C).
3. No transaction in which recognised credit risk mitigation techniques are used should receive a higher regulatory capital requirement than the same transaction where such techniques are not used.

Use of credit risk mitigation

4. An ADI that utilises credit risk mitigation must select one of the following approaches and apply that approach to all of the ADI's on-balance sheet assets and off-balance sheet banking book exposures that are subject to risk mitigation:
 - (a) the simple approach to credit risk mitigation; or
 - (b) the comprehensive approach to credit risk mitigation.⁴⁹

The ADI must advise APRA which of these credit risk mitigation approaches it has chosen to use for banking book exposures.

5. For trading book exposures, an ADI must use the comprehensive approach to credit risk mitigation where collateral is pledged against counterparty risk exposure.

Treatment of collateral

6. As detailed in Attachment L, in the simple approach to credit risk mitigation, if a claim on a counterparty is secured against eligible collateral (as defined in paragraph 10 of this Attachment), the secured portion of the claim must be weighted according to the risk-weight appropriate to the collateral (unless that produces a higher risk-weight than would be applicable to the original counterparty, in which case the risk-weight appropriate to that counterparty must apply). The unsecured portion of the claim must be weighted according to the risk-weight applicable to the original counterparty (refer to Attachments A, B, C, D, E and F).

⁴⁹ Refer to Attachments N and O.

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7. A regulatory capital requirement will be applied to an ADI on either side of a collateralised transaction. For example, both repurchase and reverse repurchase agreements will be subject to regulatory capital requirements. Likewise, both sides of a securities lending and borrowing transaction will be subject to explicit regulatory capital requirements, as will the posting of securities in connection with a derivative exposure or other borrowing.

Treatment of guarantees

8. If a claim on a counterparty is secured by a guarantee from an eligible guarantor (refer to paragraph 12 of this Attachment), the portion of the claim that is supported by the guarantee is to be weighted according to the risk-weight appropriate to the guarantor (unless the risk-weight appropriate to the original counterparty is lower). The unsecured portion of the claim must be weighted according to the risk-weight applicable to the original counterparty (refer to Attachments A, B, C, D, E and F).

Treatment of pools of credit risk mitigation techniques

9. If an ADI has multiple credit risk mitigation techniques covering a single exposure (e.g. where both collateral and a guarantee partially cover an exposure), the ADI will be required to divide the exposure into portions covered by each type of credit risk mitigation technique. The risk-weighted assets of each portion must be calculated separately (and, again, the risk-weighting appropriate to the original counterparty may be taken into account where it is lower than that appropriate to the security or guarantee). Where credit protection provided by a single guarantor has different maturities, these must also be divided into separate portions.

Eligible collateral, guarantees and guarantors

10. Subject to the conditions set out in Attachment K, the following forms of collateral may be recognised as eligible collateral under the simple approach to credit risk mitigation:
 - (a) cash (as well as certificates of deposit and bank bills issued by the lending ADI) on deposit with the ADI incurring the counterparty exposure;⁵⁰
 - (b) gold bullion;
 - (c) subject to paragraph 7 of Attachment K, debt securities rated by a recognised ECAI where these debt securities have an external rating grade⁵¹ of either:

⁵⁰ Cash-funded credit linked notes issued by the ADI against exposures in the banking book which fulfil the criteria for credit derivatives (refer to Attachment P) can be treated as cash collateralised transactions. Where cash on deposit, certificates of deposit and bank bills issued by the lending ADI are held as collateral at a third-party ADI or overseas bank in a non-custodial arrangement, if they are pledged or assigned to the lending ADI and the pledge or assignment is unconditional and irrevocable, the exposure amount covered by the collateral may receive the risk-weight of the third-party ADI or overseas bank as per Attachment B.

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- (i) four (or better) for long-term securities issued by: Australian Commonwealth, State and Territory governments in Australia; central, state and regional governments in other countries; the Reserve Bank of Australia; central banks in other countries; and the international banking agencies and multilateral regional development banks that qualify for a zero per cent risk-weight as per Attachment B; or
 - (ii) three (or better) for short-term or long-term securities when issued by other entities including ADIs, overseas banks,⁵² Australian and international local governments and corporates;
- (d) subject to paragraph 7 of Attachment K, debt securities not rated by a recognised ECAI where these securities are issued by an ADI or overseas bank as senior debt and are listed on a recognised exchange. This is subject to the proviso that all rated issues of the same seniority by the issuing ADI or overseas bank have a long-term or short-term external rating grade of at least three (refer to Attachment D) and the ADI holding the debt security has no information suggesting that the debt security justifies a rating below this level; and
 - (e) subject to paragraph 7 of Attachment K, units in a listed trust where the unit price of the trust is publicly quoted on a daily basis and the listed trust is limited to investing in the instruments noted in paragraphs 10(a) to 10(d) of this Attachment.⁵³
11. Claims secured or collateralised in other ways (e.g. by insurance contracts, put options, forward sales contracts or agreements) are not considered to be covered by eligible collateral.
12. An eligible guarantee is a guarantee that meets the conditions in paragraph 13 of this Attachment and in attachment M and is provided by one of the following eligible guarantors:
- (a) Commonwealth, State, Territory and local governments (including State and Territory central borrowing authorities) in Australia; central, state and local governments in other countries; public sector entities in Australia and overseas; central banks, ADIs and overseas banks; international banking agencies and multilateral regional development banks (where these guarantors have a lower risk-weight than the counterparty); and
 - (b) other entities with an external rating grade⁵⁴ of two or better.⁵⁵

⁵¹ Refer to Attachment D.

⁵² Refer to footnote 4.

⁵³ The use of derivative instruments by a listed unit trust to hedge investments listed in paragraphs 10(a) to 10(d) of this Attachment would not prevent the listed unit trust from being recognised as eligible financial collateral.

⁵⁴ Refer to footnote 51.

⁵⁵ This would include guarantees provided by parent, subsidiary and affiliate companies when they have a lower risk-weight than the obligor.

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13. The only collateral and guarantees that are eligible for credit risk mitigation purposes are those that are actually posted or otherwise provided under a legally enforceable agreement. A commitment to provide collateral or a guarantee is not recognised as an eligible credit risk mitigation technique for capital adequacy purposes until the commitment to do so is actually fulfilled.

DRAFT**Attachment K****Minimum conditions for the recognition of credit risk mitigation techniques under the simple approach to credit risk****Requirements for use of any credit risk mitigation technique**

1. In order for an ADI to obtain capital relief for use of a credit risk mitigation technique, all documentation used in collateralised transactions and for documenting guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. The ADI must have undertaken sufficient legal review to be satisfied with the legal enforceability of the technique and its documentation. The ADI will be expected to undertake periodic reviews to confirm the ongoing enforceability of the technique and its documentation.
2. An ADI must have policies and procedures to manage the risks associated with their credit risk mitigation techniques. Such risks include legal, operational, liquidity and market risks.
3. In order to obtain capital relief in respect of any credit risk mitigation technique, an ADI must meet the disclosure requirements detailed in *Prudential Standard APS 330 Market Disclosure (APS 330)*.

Minimum conditions for collateralised transactions

4. There must be a formal written contractual agreement between the lender (or party holding the claim) and the party lodging the collateral which establishes the lender's direct, explicit, irrevocable and unconditional recourse to the collateral.⁵⁶
5. The legal mechanism by which collateral is pledged or transferred must allow an ADI the right to liquidate or take legal possession of the collateral in a timely manner, in the event of the default, insolvency or bankruptcy (other relevant credit events permitting enforcement may also be set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). The ADI must take all steps necessary to fulfil requirements under the law applicable to the ADI's interest in the collateral for obtaining and maintaining an enforceable security interest. This includes clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed and that the collateral can be liquidated promptly.
6. In the event of default, any requirement on the lender to serve notice on the party lodging the collateral must not unnecessarily impede the lender's recourse to the collateral.

⁵⁶ In the case of cash collateral, this may include a contractual right of set-off on credit balances, however, a common law right of set-off is insufficient on its own to satisfy this condition.

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7. Eligible collateral in the form of securities issued by the counterparty to the credit exposure (or by any person or entity related or associated with the counterparty) is considered to have a material positive correlation with the credit quality of the original counterparty and is therefore not eligible collateral.
8. With the exception of cash collateral,⁵⁷ collateral must be held by an independent custodian, or an equally independent third party, or by the ADI. Where the collateral is held by an independent custodian or an equally independent third party, the ADI must take reasonable steps to ensure that the custodian or third party segregates the collateral from its own assets.
9. Where collateral is lodged with an overseas branch of the ADI, the branch holding the collateral must be bound to act in accordance with the agreement between the ADI and the party lodging the collateral.
10. Where collateral is lodged by a third party, that third party must also indemnify or guarantee the borrower's obligations (or those of the party on which a claim is held) to the lender. The lender must ensure that the arrangement will not fail for lack of consideration.

Additional conditions specific to cash collateral

11. Cash collateral must not be lodged with an entity other than the ADI, except where:
 - (a) the ADI and the entity holding the collateral belong to the same consolidated group; and
 - (b) the entity holding the collateral is bound to act in accordance with the agreement between the ADI and the party lodging the collateral.
12. Where cash collateral lodged is in the form of a certificate of deposit or bank bill issued by the lending ADI, or any eligible entity described in paragraph 11 of this Attachment, the ADI must retain physical possession of the instrument until the collateral obligations are extinguished.

⁵⁷ For the lodgement of cash collateral, refer to paragraph 11 of this Attachment.

DRAFT**Attachment L****Specific requirements for use of the simple approach to credit risk mitigation**

1. For collateral to be eligible collateral in the simple approach to credit risk mitigation, it must be pledged for at least the life of the exposure and be marked-to-market with a minimum frequency of six months. The release of collateral by the lending ADI must be conditional upon the repayment of the exposure. Collateral may be reduced in proportion to the amount of the reduction in the exposure amount.
2. Those portions of claims collateralised by the market value (at the most recent revaluation) of eligible collateral (refer to paragraph 10 of Attachment J) may receive the risk-weight applicable to the collateral instrument (refer to Attachments B, C and D). The risk-weight on the collateralised portion will be subject to a floor of 20 per cent except under the conditions specified in paragraphs 3 to 6 of this Attachment. The remainder of the claim is assigned the risk-weight appropriate to the counterparty (refer to Attachments A, B, C, D, E, and F).

Exceptions to the 20 per cent risk-weight floor

3. A zero per cent risk-weight may be applied to collateralised transactions where the exposure and the collateral are denominated in the same currency and either:
 - (a) the collateral is cash on deposit,⁵⁸ or
 - (b) the collateral is in the form of sovereign or public sector entity securities eligible for a zero per cent risk-weight as detailed in Attachments A, B, C and D, and the market value of the collateral has been discounted by 20 per cent.
4. Repurchase/reverse repurchase agreements and securities lending/borrowing transactions which fulfil the criteria in paragraph 23 of Attachment O and are with a core market participant, as defined in paragraph 24 of Attachment O, may receive a risk-weight of zero per cent. If the counterparty to the transactions is not a core market participant, the transaction should be risk-weighted at 10 per cent.
5. Over-the-counter (**OTC**) derivative transactions in the banking book may be risk-weighted at zero per cent where:
 - (a) they are subject to daily mark-to-market;
 - (b) they are fully collateralised by cash; and
 - (c) there is no currency mismatch.

⁵⁸ As defined in paragraph 10(a) of Attachment J.

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6. OTC derivative transactions collateralised by sovereign or public sector entity securities that qualify for a zero per cent risk-weight, as detailed in Attachments A, B, C, and D may be risk-weighted at 10 per cent.

DRAFT**Attachment M****Guarantees under the simple approach to credit risk mitigation**

1. A guarantee must represent a direct claim on the guarantor with the extent of the cover being clearly defined and incontrovertible. A guarantee must be irrevocable; there must be no clause in the guarantee that would allow the guarantor to cancel unilaterally the cover of the guarantee or that would increase the effective cost of cover as a result of deteriorating credit quality in the guaranteed exposure.⁵⁹ A guarantee must also be unconditional; there should be no clause in the guarantee outside the direct control of an ADI that could prevent the guarantor from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the due payment(s).
2. A claim that is indirectly guaranteed by the Australian Government (i.e. guarantee of guarantee such as the Commonwealth's guarantee of the entity which provides the guarantee) may be treated as guaranteed by the Australian Government provided that:
 - (a) the indirect guarantee covers all credit risk elements of the claim;
 - (b) both the original guarantee and the indirect guarantee meet all the operational requirements for guarantees except that the indirect guarantee need not be direct and explicit to the original claim; and
 - (c) the ADI is satisfied that the cover of the indirect guarantee is robust and that there is no historical evidence that suggests that the coverage of the indirect guarantee is not equivalent to that of a direct guarantee of the Australian Government.
3. Letters of comfort do not qualify as eligible guarantees for credit risk mitigation purposes. Claims secured against letters of comfort must be weighted according to the risk-weight applicable to the original counterparty (unless there is also eligible collateral or an eligible guarantee supporting the underlying obligation).

Operational requirements

4. In addition to the legal certainty requirements detailed in paragraph 1 of Attachment K, in order for a guarantee to be recognised the following conditions must be satisfied:
 - (a) on the qualifying default/non-payment of the counterparty, the ADI has the capacity to pursue, in a timely manner, the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the ADI or the guarantor may assume the future

⁵⁹ Note, the irrevocability condition does not require that the guarantee and the exposure be maturity matched; rather that the maturity agreed ex ante may not be reduced ex post by the guarantor. Paragraphs 15 and 16 of this Attachment set out the treatment of call options in determining remaining maturity for credit protection.

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payment obligations of the counterparty covered by the guarantee. The ADI must have the right to receive any such payments from the guarantor without first having to take legal action in order to pursue the counterparty for payment;

- (b) the guarantee is an explicitly documented obligation assumed by the guarantor; and
- (c) except as noted in this paragraph, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction. Where a guarantee covers payment of principal only, interest and other amounts not covered by the guarantee should be treated as the uncovered portion in accordance with paragraph 5 of this Attachment.

Risk-weights

- 5. Where an ADI has obtained a guarantee from an eligible guarantor (refer to paragraph 12 of Attachment J), the protected portion of the exposure may be assigned the risk-weight of the protection provider. The uncovered portion of the exposure must be assigned the risk-weight of the underlying counterparty.
- 6. Where the guarantee provides for a materiality threshold on payments below which no payment will be made in the event of loss, this is equivalent to retained first loss positions and the ADI obtaining the credit protection must deduct 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital. The deduction will be capped at the amount of capital the ADI would be required to hold against the full value of the exposure.

Proportional cover

- 7. Where there is partial coverage of an exposure by a guarantee and the covered and uncovered portions are of equal seniority (i.e. the ADI and the guarantor share losses on a pro-rata basis), capital relief will be afforded on a proportional basis. This means that the covered portion of the exposure will receive the treatment applicable to eligible guarantees with the remainder treated as unsecured.

Tranched cover

- 8. Where there is partial coverage of an exposure by a guarantee and there is a difference in seniority between the covered and uncovered portions of the exposure, the securitisation rules detailed in APS 120 may apply.

Currency mismatch

- 9. Where the guarantee is denominated in a different currency from that in which the exposure is denominated (i.e. there is a currency mismatch), the amount of the exposure deemed to be protected (G_A) will be reduced by the application of an adjustment (hereinafter called “haircut” (H_{FX})) as follows:

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$$G_A = G \times (1 - H_{FX})$$

where:

G = nominal amount of the guarantee

H_{FX} = haircut appropriate for the currency mismatch between the guarantee and the underlying obligation

10. The haircuts are the same as those applied to collateral in the comprehensive approach to credit risk mitigation (refer to Attachments N and O). If an ADI uses the comprehensive approach to credit risk mitigation and it uses the standard supervisory haircuts, the haircut to be applied for a currency mismatch will be eight per cent (assuming daily mark-to-market). If the ADI generally uses the comprehensive approach to credit risk mitigation and it uses own-estimate haircuts, the estimates for a currency mismatch must be based on a 10 business day holding period. Where the ADI generally uses the simple approach to credit risk mitigation, it may use the standard supervisory haircut of eight per cent for the currency mismatch (assuming daily mark-to-market) or own-estimate haircuts based on a 10 business day holding period.
11. Using the formula detailed in paragraph 22 of Attachment O, haircuts must be scaled up depending on the actual frequency of revaluation of the guarantee.

Maturity mismatch

12. A maturity mismatch exists where the residual maturity of a guarantee is less than the maturity of the exposure covered by the guarantee.
13. Where there is a maturity mismatch, a guarantee will only be recognised when the original maturity of the guarantee is greater than or equal to 12 months. Guarantees with an original term of less than 12 months will not be eligible guarantees unless the term matches the maturity of the underlying exposure. In all cases where there is a maturity mismatch, a guarantee will not be an eligible guarantee when the term has a residual maturity of three months or less.
14. Where the residual maturity of the guarantee is less than the maturity of the exposure, a maturity mismatch adjustment, as detailed in paragraph 17 of this Attachment, will be required for the purpose of calculating risk-weighted assets.

Definition of maturity

15. The effective maturity of the underlying exposure must be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any grace period.
16. For a guarantee, any clause within the documentation supporting the transaction that may reduce the term of the guarantee must be taken into account so that the shortest possible effective maturity is used. Where the guarantor has the capacity to reduce the term of the guarantee, the maturity will always be the first date on which the guarantor can exercise its discretion. Where an ADI has the

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discretion to reduce the term of the guarantee, and the terms of the transaction at origination of the exposure contain a positive incentive for the ADI to exercise its discretion before contractual maturity, the remaining time to the first date when the discretion can be exercised will be deemed to be the effective maturity.

Adjustment for maturity mismatch

17. Where there is a maturity mismatch between a guarantee and the exposure covered by the guarantee, the following adjustment should be applied:

$$Pa = P \times (t-0.25)/(T-0.25)$$

where:

Pa = value of the guarantee adjusted for maturity mismatch

P = guarantee amount adjusted for any haircuts

t = min (T, residual maturity of the guarantee) expressed in years

T = min (5, residual maturity of the exposure) expressed in years

DRAFT**Attachment N****General principles for use of the comprehensive approach to credit risk mitigation**

1. This Attachment, in conjunction with Attachment O, sets out the comprehensive approach to credit risk mitigation which an ADI using the standardised approach to credit risk may use in determining the appropriate risk-weight for a transaction secured by eligible collateral and/or guarantee.
2. No additional credit risk mitigation will apply for capital adequacy purposes on claims where the risk-weight is mapped from an issue-specific rating and that rating already reflects credit risk mitigation (refer to Attachment C).
3. No transaction in which recognised credit risk mitigation techniques are used should receive a higher regulatory capital requirement than the same transaction where such techniques are not used.

Use of credit risk mitigation

4. An ADI that wishes to use credit risk mitigation must select one of the following approaches and apply that approach to all of the ADI's on-balance sheet assets and off-balance sheet banking book exposures that are subject to risk mitigation:
 - (a) the simple approach to credit risk mitigation;⁶⁰ or
 - (b) the comprehensive approach to credit risk mitigation.

The ADI must advise APRA which of these credit risk mitigation approaches it has chosen to use for banking book exposures.

5. For trading book exposures, an ADI must use the comprehensive approach to credit risk mitigation where collateral is pledged against counterparty risk exposure.

Recognition criteria

6. For the purposes of this Prudential Standard, an exchange or clearing house is considered "recognised" where:
 - (a) it is subject to authorisation, licensing or other means of recognition by a government or other competent authority;
 - (b) it has rules, issued or approved, by the government or other competent authority defining the conditions:
 - (i) for the operation of the exchange or clearing house;

⁶⁰ Refer to Attachments J, K, L and M.

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- (ii) for access to the exchange or clearing house; and
 - (iii) that must be satisfied by a contract before it can be dealt on the exchange or payment effected by the clearing house;
- (c) it has a clearing mechanism that provides for contracts dealt through the exchange or clearing house to be settled;
 - (d) functions regularly;
 - (e) the exchange or clearing house has a prudent and frequent margining system where relevant;
 - (f) the clearing house guarantees settlement and the exchange requires settlement on a particular day as applicable;
 - (g) members of the exchange or clearing house are themselves subject to supervision by the exchange, clearing house or competent authority; and
 - (h) the operations of the exchange or clearing house in turn are supervised by government or other competent authority.

Treatment of collateral

7. Under the comprehensive approach to credit risk mitigation, an ADI must calculate an adjusted exposure amount after risk mitigation for a collateralised transaction (refer to paragraph 11 of this Attachment for eligible collateral under this approach). In calculating the adjusted exposure amount after risk mitigation, haircuts are applied to both the collateral and the exposure to take into account possible future price fluctuations. The adjusted exposure amount after risk mitigation must be weighted according to the risk-weight of the counterparty (refer to Attachments A, B, C, D, E and F) to obtain the risk-weighted asset amount for the collateralised transaction.
8. An ADI on either side of a collateralised transaction must apply a regulatory capital requirement. For example, both repurchase and reverse repurchase agreements will be subject to regulatory capital requirements. Likewise, both sides of a securities lending and borrowing transaction will be subject to explicit regulatory capital requirements, as will the posting of securities in connection with a derivative exposure or other borrowing.

Treatment of guarantees

9. The treatment of guarantees under the comprehensive approach to credit risk mitigation must be the same as that detailed in the simple approach to credit risk mitigation (refer to Attachments J, K, L and M).

Treatment of pools of credit risk mitigation techniques

10. Where an ADI has multiple credit risk mitigation techniques covering a single exposure (e.g. where both eligible collateral and guarantee partially cover an

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exposure), the ADI must divide the exposure into portions covered by each type of credit risk mitigation technique. The risk-weighted assets of each portion must be calculated separately. Where credit protection provided by a single guarantor has different maturities, these must also be divided into separate portions.

Eligible collateral

11. In addition to the items listed in paragraph 10 of Attachment of J and subject to the conditions set out in Attachment K, the following forms of collateral are eligible collateral under the comprehensive approach to credit risk mitigation:
 - (a) equities (including convertible bonds) that are included in a main index or listed on a recognised exchange; and
 - (b) units in listed trusts that invest in equities as per paragraph 11(a) of this Attachment.
12. Claims secured or collateralised in other ways (e.g. by insurance contracts, put options, forward sales contracts or agreements) are not considered to be covered by eligible collateral.
13. The only collateral that are eligible for credit risk mitigation purposes are those that are actually posted or otherwise provided under a legally enforceable agreement. A commitment to provide collateral must not be recognised as an eligible credit risk mitigation technique for capital adequacy purposes until the commitment to do so is actually fulfilled.

Minimum conditions for the recognition of credit risk mitigation techniques

14. The minimum conditions for the recognition of credit risk mitigation techniques detailed in the simple approach to credit risk mitigation (refer to Attachment K) also apply to the comprehensive approach to credit risk mitigation.

DRAFT**Attachment O****Specific requirements for use of the comprehensive approach to credit risk mitigation**

1. Under the comprehensive approach to credit risk mitigation, an ADI must calculate the adjusted exposure amount to a counterparty to take into account the effects of any eligible collateral (as defined in paragraph 11 of Attachment N) that the ADI has taken. Using haircuts, the ADI must adjust both the amount of the exposure to the counterparty (**volatility-adjusted exposure amount**) and the value of the collateral (**volatility-adjusted collateral amount**) in order to take into account possible future price fluctuations of the exposure or collateral.⁶¹
2. Where the exposure and collateral are held in different currencies, an ADI must make an additional downwards adjustment to the volatility-adjusted collateral amount to take into account possible future fluctuations in exchange rates.
3. The difference between the volatility-adjusted exposure amount and the volatility-adjusted collateral amount (including any required adjustment for foreign exchange movements) is the adjusted exposure amount after risk mitigation (refer to calculation in paragraph 7 of this Attachment). An ADI must risk-weight the adjusted exposure amount after risk mitigation using the risk-weight applicable to the counterparty to the original exposure as detailed in Attachments A, B, C, D, E and F.
4. An ADI may use standard supervisory haircuts or, subject to meeting the requirements in paragraphs 14 to 19 of this Attachment and approval by APRA under paragraph 13 of this Attachment, its own-estimate haircuts using internal estimates of market price volatility. Where the use of own-estimate haircuts is allowed, the estimates must cover the full range of relevant instruments used by the ADI excluding portfolios that APRA has determined in writing are immaterial. The ADI may use standard supervisory haircuts for those immaterial portfolios.
5. As detailed in paragraphs 20 to 22 of this Attachment, the size of the individual haircuts depends upon the type of instrument, type of transaction and the frequency of remargining or revaluing. Haircuts may need to be scaled up using a prescribed formula depending on the frequency of actual remargining or revaluing and in the case where an ADI uses own-estimate haircuts, where the calculated volatility on a holding period is different from the minimum specified holding period.
6. For certain types of repurchase and reverse repurchase agreements (broadly speaking, government bond repurchase and reverse repurchase agreements as defined in paragraphs 23 and 24 of this Attachment), APRA will allow an ADI to apply a zero haircut in calculating the exposure amount after risk mitigation.

⁶¹ Exposure amounts may vary where, for example, securities are lent.

DRAFT**Calculation of regulatory capital requirement for collateralised transactions**

7. For a collateralised transaction under the comprehensive approach to credit risk mitigation, the adjusted exposure amount after risk mitigation is calculated as follows:

$$E^* = \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\}$$

where:

E^* = the adjusted exposure amount after risk mitigation

E = current value of the exposure

H_e = haircut appropriate to the exposure

C = the current value of the collateral

H_c = haircut appropriate to the collateral

H_{fx} = haircut appropriate for currency mismatch between the collateral and exposure

8. In the case of OTC derivatives, $E \times (1 + H_e)$ is replaced by the credit equivalent amount of the OTC derivative calculated using the current exposure (mark-to-market) method, i.e. replacement cost and potential future exposure.⁶²
9. Where the collateral is a basket of assets, the haircut on the basket will be $H = \sum_i a_i H_i$, where a_i is the weight of the asset in the basket (as measured by units of currency) and H_i is the haircut applicable to that asset.

Standard supervisory haircuts

10. Unless an ADI has obtained APRA approval under paragraph 13 of this Attachment to use its own-estimates for haircuts, an ADI must use standard supervisory haircuts in calculating volatility-adjusted exposure and collateral amounts.

⁶² Refer to Attachments G, H and I.

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11. The standard supervisory exposure and collateral haircuts⁶³ (**H**), expressed as percentages, are as follows:

External rating grade for debt securities⁶⁴	Residual maturity	Sovereigns⁶⁵	Other issuers⁶⁶
1 (long- and short-term)	≤ 1 year	0.5	1
	>1 year, ≤ 5 years	2	4
	> 5 years	4	8
2-3 (long- and short-term) and unrated bank securities per Attachment J paragraph 10(d)	≤ 1 year	1	2
	>1 year, ≤ 5 years	3	6
	> 5 years	6	12
4 (long-term)	All	15	N/A
Main index equities (including convertible bonds) and gold		15	
Other equities (including convertible bonds) listed on a recognised exchange		25	
Units in listed trusts		Highest haircut applicable to any security in which the trust can invest.	
Cash in the same currency ⁶⁷		0	
Currency mismatch		8	

12. For transactions in which an ADI lends non-eligible instruments, the haircut to be applied on the exposure must be the same as that for other equities, i.e. 25 per cent.

⁶³ These standard supervisory haircuts assume daily mark-to-market, daily remargining and a 10 business day holding period.

⁶⁴ Refer to Attachment D.

⁶⁵ Sovereigns include Australian Commonwealth, State and Territory governments, central, state and regional governments of other countries; the Reserve Bank of Australia and central banks of other countries. This includes the international banking agencies and multilateral regional development banks qualifying for a zero per cent risk-weight as per Attachment B.

⁶⁶ This includes ADIs, overseas banks, local governments in Australia and other countries and corporates.

⁶⁷ Eligible cash collateral is specified in Attachments J and K.

DRAFT**Own-estimates for haircuts**

13. If approved by APRA in writing, an ADI may calculate its own exposure and collateral haircuts (H) based on internal estimates of market price and foreign exchange volatilities. Approval to calculate own haircuts will be conditional upon APRA being satisfied that the ADI meets, and continues to meet, the conditions set out in paragraphs 14 to 19 of this Attachment.

Own-estimate haircut categories

14. For debt securities with an external rating grade below three and for equities which meet the eligibility criteria of this Attachment, haircuts must be calculated for each individual security.
15. For debt securities with a long-term or short-term external rating grade of three or better, an ADI may be permitted to calculate a volatility estimate for a group (or category) of securities. In determining relevant categories, the ADI must take into account the type of issuer of the securities, the relevant rating, residual maturity and modified duration. Volatility estimates must be representative of the securities actually included in each of the ADI's categories.
16. An ADI must estimate separately the volatility of the collateral instrument and any foreign exchange mismatch. That is, estimated volatilities will not be permitted to include estimation of the correlation between unsecured exposures, collateral and exchange rates.
17. An ADI that calculates its own estimates for haircuts must follow the guidelines for maturity mismatches as per the requirements in paragraphs 25 to 30 of this Attachment.

Quantitative criteria for calculating own-estimates for haircuts

18. APRA will not prescribe the type of model an ADI must use in order to estimate its own haircuts. In order to be approved by APRA under paragraph 13 of this Attachment, the ADI's model must capture all the material risks and satisfy the following quantitative criteria:
 - (a) a 99th percentile one-tailed confidence interval;
 - (b) the minimum holding period will be dependent on the type of transaction and the frequency of remargining or marking-to-market. The minimum holding periods for different types of transactions are detailed in paragraph 21 of this Attachment. The ADI may use haircut numbers calculated according to shorter holding periods, provided these estimates are scaled up to the appropriate holding period as per the formula detailed in paragraph 22 of this Attachment;
 - (c) the ADI must take into account the illiquid nature of lower-quality assets. Holding periods will be required to be adjusted upward in cases where the minimum holding period is inappropriate given the illiquid nature of the collateral. APRA must be satisfied that any adjustments made by the ADI

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are adequate. The ADI should also identify where historical data may understate potential volatility (e.g. pegged currencies). Such cases must be dealt with by subjecting the data to stress testing;

- (d) the ADI must use a minimum of one year of historical observations for calculating haircuts. Where the ADI uses a weighting scheme or other methods for the historical observation period, the effective observation period must be at least one year (i.e. the weighted average time lag of the individual observations cannot be less than six months); and
- (e) data sets upon which own-estimate haircuts are based must be updated no less frequently than once every three months and reassessed whenever market prices are subject to material change. Accordingly, haircuts must be computed at least every three months. APRA may also require the ADI to calculate its haircuts using a shorter observation period if this is justified by a significant upsurge in price volatility.

Qualitative criteria for calculating own-estimates for haircuts

19. In addition to the quantitative criteria detailed in paragraph 18 of this Attachment, an ADI must satisfy the following qualitative criteria in order to obtain approval to use own-estimates for haircuts:
- (a) the ADI must have robust processes in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operation of the risk measurement system;
 - (b) the estimated volatility data (and holding period) must be used in the day-to-day risk management process of the ADI;
 - (c) the risk measurement system must be used in conjunction with internal exposure limits; and
 - (d) an independent review of the risk measurement system must be carried out regularly by the ADI's internal audit function. A review of the overall risk management process should be undertaken at regular intervals. Reviews must be undertaken at least on an annual basis and, at a minimum, they must specifically address:
 - (i) the integration of risk measures into daily risk management;
 - (ii) the validation of any significant change in the risk measurement process;
 - (iii) the accuracy and completeness of data;
 - (iv) the verification of the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources; and

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- (v) the accuracy and appropriateness of volatility assumptions and measurement calculations.

Adjustments to standard supervisory and own-estimate haircuts for different holding periods and non-daily mark-to-market or remargining

20. For some transactions, depending on the nature and frequency of the revaluation and remargining provisions, different holding periods are appropriate. For this purpose, APRA's framework distinguishes between repo-style transactions (i.e. repurchase/reverse repurchase agreements and securities lending/borrowing transactions), other capital-market-driven transactions (i.e. OTC derivative transactions and margin lending) and secured lending.
21. The minimum holding periods for these products are summarised in the following table:

Transaction type	Minimum holding period	Condition
Repo-style transactions	Five business days	Daily remargining
Other capital market transactions	Ten business days	Daily remargining
Secured lending	Twenty business days	Daily revaluating

22. When remargining or revaluation is undertaken less frequently than the minimum specified in paragraph 21 of this Attachment, the minimum haircut numbers must be scaled up depending on the actual number of business days between remargining or revaluation using the formula detailed below. This adjustment is required for both standard supervisory and own-estimate haircuts.

$$H = H_M \sqrt{\frac{N_R + (T_M - 1)}{T_M}}$$

where:

H = haircut

H_M = haircut under the minimum holding period

T_M = minimum holding period for the type of transaction

N_R = actual number of business days between remargining for capital market transactions or revaluation for secured transactions

When an ADI calculates the volatility on a holding period (T_N days) which is different from the specified minimum holding period detailed in paragraph 21 of this Attachment (T_M), the haircut under the minimum holding period (H_M) must be calculated using the formula detailed below. This adjustment is required for own-estimate haircuts.

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$$H_M = H_N \sqrt{\frac{T_M}{T_N}}$$

where:

T_N = holding period used by the ADI for deriving H_N

H_N = haircut based on the holding period T_N

Conditions for a zero haircut

23. For repurchase/reverse repurchase agreements and securities lending/borrowing transactions, where the counterparty is a core market participant (as defined in paragraph 24 of this Attachment), an ADI may apply a haircut of zero, if the following conditions are satisfied:
- (a) both the exposure and the collateral are cash, a sovereign security or public sector entity security, qualifying for a zero per cent risk-weight as per Attachments A, B, C, and D;
 - (b) both the exposure and the collateral are denominated in the same currency;
 - (c) either the transaction is overnight, or both the exposure and the collateral are marked-to-market daily and are subject to daily remargining;
 - (d) following a counterparty's failure to remargin, the time that is required between the last mark-to-market before the failure to remargin and the liquidation of the collateral must be no more than four business days;⁶⁸
 - (e) the transaction is settled across a settlement system that is regularly used by significant market participants for that type of transaction;
 - (f) the documentation covering the agreement is standard market documentation for repurchase/reverse repurchase agreements and securities lending/borrowing transactions in the securities concerned;
 - (g) the transaction is governed by documentation specifying that if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver a margin call or otherwise defaults, the transaction is immediately terminable; and
 - (h) upon any default event, regardless of whether the counterparty is insolvent or bankrupt, the ADI has an unequivocal, legally enforceable right to seize and liquidate the collateral immediately for its benefit.

⁶⁸ This does not require the ADI always to liquidate the collateral but rather to have the capability to do so within the given time frame.

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24. For the purpose of applying a zero haircut, the following entities are considered core market participants:
- (a) the Australian Government and the Reserve Bank of Australia;
 - (b) ADIs and overseas banks;⁶⁹
 - (c) other financial companies (including insurance companies) eligible for a 20 per cent risk-weight as per Attachments A, B, C, and D; and
 - (d) recognised clearing organisations.

Maturity mismatch

25. A maturity mismatch exists where the residual maturity of the term of lodgement of the collateral is less than the maturity of the exposure covered by the collateral.
26. Where there is a maturity mismatch, the collateral may only be recognised when the residual maturity of the term of lodgement of the collateral is greater than or equal to 12 months. If the residual maturity of the term of lodgement of the collateral is less than 12 months, the collateral may not be recognised as eligible collateral unless the term of lodgement matches the maturity of the underlying exposure. In all cases where there is a maturity mismatch, collateral will not be eligible when the residual maturity of the term of lodgement is three months or less.
27. Where the residual maturity of the term of lodgement of the collateral is less than the maturity of the exposure, a maturity mismatch adjustment, as detailed in paragraph 30 of this Attachment, will be required for the purpose of calculating risk-weighted assets.

Definition of maturity

28. The effective maturity of the underlying exposure must be taken to be the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any grace period.
29. With respect to collateral, an ADI must take into account any clause within the documentation supporting the transaction which may reduce the term of lodgement of the collateral, to ensure that the shortest possible effective maturity is used. Where the protection provider has the capacity to reduce the term of lodgement of the collateral, the maturity will always be the first date upon which the protection provider can exercise its discretion. Where the ADI has the discretion to reduce the term of lodgement of the collateral, and the terms of the transaction at origination of the exposure contain a positive incentive for the ADI to exercise its discretion before contractual maturity, the remaining time to the first date when the discretion can be exercised will be deemed to be the effective maturity.

⁶⁹ Refer to footnote 4.

DRAFT**Adjustment for maturity mismatch**

30. Where there is a maturity mismatch between collateral and the exposure secured by the collateral, the following adjustment will be applied:

$$Pa = P \times (t-0.25)/(T-0.25)$$

where:

Pa = value of the collateral adjusted for maturity mismatch

P = collateral amount adjusted for any haircuts

t = min (T, residual maturity of the term of lodgement of the collateral)
expressed in years

T = min (5, residual maturity of the exposure) expressed in years

DRAFT**Attachment P****Credit derivatives in the banking book**

1. An ADI that transacts more complex credit derivatives that fall outside the scope of this Attachment must, prior to execution of a relevant credit derivative contract, obtain APRA's written approval regarding the appropriate regulatory capital treatment for such transactions. The credit derivatives recognised in this Attachment are:
 - (a) single-name credit default and certain total-rate-of-return swaps;
 - (b) cash-funded credit-linked notes; and
 - (c) first and second-to-default credit derivative basket products.
2. Where a credit derivative is used for the purpose of credit risk mitigation (or **buying credit protection**), this Attachment must be read in conjunction with Attachments J, K, L, and M. Where an ADI buys credit protection through a credit derivative that forms part of a **synthetic securitisation**, this Attachment must also be read in conjunction with APS 120.
3. Where credit derivatives are used for the purpose of acquiring credit risk exposure (or **selling credit protection**), this Attachment must be read in conjunction with Attachments A, B, C, D, E, F, G, H, and I.
4. An ADI must include in its trading book total-rate-of-return swaps, except those that have been transacted to hedge a banking book credit exposure in accordance with the requirements in this Attachment.
5. An ADI must include open short positions in credit derivatives in its trading book. An exception to this requirement may be granted by APRA, in writing, on a one-off approval basis.

Definitions

6. The following definitions have been used in this Attachment when describing a credit derivative transaction:
 - (a) **credit-event payment** – the amount that is payable by the credit protection provider to the credit protection buyer under the terms of the credit derivative contract following the occurrence of a credit event. The payment can be in the form of **physical settlement** (payment of par in exchange for physical delivery of a deliverable obligation of the reference entity), **cash settlement** (payment of the par value of the reference obligation less that obligation's recovery value) or a fixed amount;
 - (b) **credit events** – events affecting the reference entity that trigger a credit-event payment under the terms of the credit derivative contract;
 - (c) **credit protection** – the extent of credit risk transference from the party

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that is buying credit protection to the party that is selling credit protection;

- (d) **deliverable obligation** – any obligation of the reference entity that can be delivered, under the terms of the credit derivative contract, if a credit event occurs. A deliverable obligation is relevant for credit derivatives that are to be physically settled;
- (e) **reference entity** – the entity or entities whose obligations are used to determine whether a credit event has occurred under the terms of the credit derivative contract;
- (f) **reference obligation** – the obligation used to calculate the amount payable when a credit-event occurs. A reference obligation is relevant for obligations that are to be cash settled (on a par-less-recovery basis); and
- (g) **underlying exposure** – the banking book exposure that is being protected by the credit derivative.

Determining the amount of credit protection purchased or sold

- 7. In order to be recognised for credit risk mitigation purposes, the credit derivative contract must not contain terms or conditions that terminate or increase the ADI's cost of the credit protection purchased if the credit quality of the underlying exposure deteriorates.

Required credit events

- 8. An ADI must ensure that, for credit risk mitigation purposes, there is sufficient credit risk transfer under each credit derivative contract. At a minimum, sufficient credit risk transfer requires that credit events under the terms of the credit derivative contract cover:
 - (a) failure to pay an amount due under the terms of the underlying exposure that is in effect at the time of such failure;⁷⁰
 - (b) the bankruptcy, insolvency or inability of the obligor of the underlying exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as those debts become due, or analogous events; and
 - (c) subject to paragraph 9 of this Attachment, the restructuring of the underlying exposure.⁷¹

⁷⁰ The grace period of the credit derivative contract must align closely with the grace period of the underlying exposure.

⁷¹ For this purpose, restructuring involves any forgiveness or postponement of principal, interest or fees that results in the charge-off, specific provision or other similar debit to the profit and loss account of the ADI and restructured items where facilities are rendered non-commercial because of concessional contractual changes related to financial difficulties of the customer as defined in APS 220.

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9. When restructuring of the underlying exposure is not included within the terms of the credit derivative contract, but all other requirements for credit risk transfer are met (refer to paragraphs 8(a) to 8(b) of this Attachment), an ADI may recognise, for capital adequacy purposes, 60 per cent of the amount of the credit protection purchased (refer to paragraph 15 of this Attachment) where the amount of credit protection purchased is less than or equal to the amount of the underlying exposure. If the amount of credit protection purchased exceeds that of the underlying exposure, the amount of eligible credit protection is capped at 60 per cent of the amount of the underlying exposure.
10. An **asset mismatch** exists where an ADI has purchased credit protection using a credit derivative and the underlying exposure which is protected by the credit derivative is different to either:
 - (i) the deliverable obligation or the reference obligation (as the case may be); or
 - (ii) the obligation specified in the credit derivative contract for the purpose of determining whether a credit event has occurred.

An asset mismatch for credit risk mitigation purposes is allowed provided:

- (a) the deliverable obligation, the reference obligation or the obligation specified in the credit derivative contract for the purpose of determining whether a credit event has occurred (as the case may be) ranks *pari passu* or more junior, in seniority of claim, relative to the underlying exposure; and
 - (b) the underlying exposure and the deliverable obligation, reference obligation or the obligation specified in the credit derivative contract for the purpose of determining whether a credit event has occurred are obligations of the same legal entity or the underlying exposure is an obligation of an entity that is unconditionally and irrevocably guaranteed by the reference entity to the credit derivative contract, and legally enforceable cross-default or cross-acceleration clauses are in place.
11. An ADI that has sold credit protection using a credit derivative must, for capital adequacy purposes, assume that 100 per cent of the credit risk is purchased irrespective of the range of specified credit events.

Materiality thresholds

12. In order to be recognised for credit risk mitigation purposes, a credit derivative contract must not contain significant materiality thresholds below which credit protection is deemed not to be provided even if a credit event occurs.
13. Subject to paragraph 12 of this Attachment, when determining the amount of credit protection purchased using a credit derivative, an ADI must have regard to any materiality threshold specified in the credit derivative contract as equivalent to a retained first loss position and deduct this amount 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital (refer to APS 111). The

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deduction will be capped at the amount of capital the ADI would be required to hold against the full value of the underlying exposure.

14. When determining the amount of credit protection sold, an ADI must assume that any materiality thresholds included in the credit derivative contract do not reduce the acquired credit risk.

Credit-event payments

15. Where the credit-event payment specified in the credit derivative contract is on the basis of cash settlement or physical settlement, the amount of credit protection purchased or sold must be set equal to the par value of the reference or deliverable obligation respectively. Where the credit-event payment is defined as a fixed amount or a percentage of the par amount, the amount of credit protection purchased or sold must be set equal to that fixed amount or as the defined percentage multiplied by the notional principal of the contract amount.

Defining the maturity of the underlying exposure

16. An ADI must define the maturity of the underlying exposure as the longest possible remaining time before the obligor of the exposure is scheduled to fulfil its obligation.

Defining the maturity of the credit derivative

17. An ADI that purchases credit protection using a credit derivative must take into account any clause within the credit derivative contract that may reduce its term so that the shortest possible effective maturity is used. For this purpose, the ADI must consider clauses that give the protection seller the capacity to reduce the term of the credit derivative and those that give the purchasing ADI, at origination of the credit derivative contract, a discretion and incentive to reduce its term. Where a credit derivative is not prevented from terminating prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay, the effective maturity of the credit derivative must be reduced by the amount of the grace period.
18. An ADI that sells credit protection using a credit derivative containing an embedded option to extend the term of the credit derivative must assume the longest possible effective maturity of the credit derivative. This must be the case regardless of any arrangements in the contract that may give either the protection buyer or the protection seller the incentive to reduce the contract term.

Credit derivatives used for credit risk mitigation purposes

19. For credit risk mitigation purposes, credit default swaps, credit-linked notes and first and second-to-default credit derivative basket products will be eligible for

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recognition, subject to meeting the requirements of this Attachment and the requirements set out in paragraphs 1 to 3 of Attachment K. Total-rate-of-return swaps may also be recognised (subject to the same requirements noted above) where an ADI records any deterioration in the value of the underlying exposure (such as by an addition to reserves) in addition to recording the net payments received on the swap as net income.

20. The only credit derivative contracts that are eligible for credit risk mitigation purposes are those that have been transacted under a legally enforceable agreement.
21. For credit mitigation purposes credit derivatives, with the exception of cash-funded credit-linked notes (refer to paragraph 34 of this Attachment), are treated in a similar manner to guarantees. This means that where an underlying exposure is protected by a credit derivative from an eligible protection seller (as defined in paragraph 23 of this Attachment), the portion of the claim that is protected by the credit derivative (or the amount of credit protection purchased as detailed in paragraph 15 of this Attachment) may be weighted according to the risk-weight appropriate to the protection seller. The unprotected portion of the underlying exposure must be weighted according to the risk-weight applicable to the original counterparty (refer to Attachments A, B, C, D, E, and F). No exposure mitigated by a recognised credit derivative should receive a higher regulatory capital requirement than the same exposure where such a credit derivative is not used.⁷²
22. An ADI must meet the disclosure requirements detailed in APS 330 in order to obtain capital relief in respect of a credit derivative.

Eligible credit protection sellers

23. In the case of credit default swaps, total-rate-of-return swaps and first- and second-to-default credit derivative basket products, an ADI may recognise the credit protection provided by the same entities that are recognised as eligible guarantors (refer to paragraph 12 of Attachment J).

Operational requirements

24. The use of credit derivatives, while reducing or transferring credit risk, may increase other risks such as legal, operational, liquidity and market risks. Accordingly, an ADI must employ robust procedures and processes to control those risks.
25. In addition to the requirements regarding legal documentation set out in paragraph 1 of Attachment K, in order to obtain capital relief from the use of a

⁷² Where an ADI buys credit protection through a credit derivative that forms part of a synthetic securitisation, this may result in a higher regulatory capital requirement than where such a credit derivative is not used. In accordance with Attachment C to APS 120, an ADI applying the standardised approach to credit risk must obtain APRA's prior written approval before it may apply the lower of the two regulatory capital requirements.

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credit derivative an ADI must meet the operational requirements detailed in paragraphs 26 to 29 of this Attachment.

26. A credit derivative must represent a direct claim on the protection seller with the extent of the credit protection being clearly defined and incontrovertible. A credit derivative must be irrevocable; there must be no clause in the credit derivative contract that would allow the protection seller to cancel unilaterally the protection of the credit derivative.⁷³ A credit derivative must also be unconditional; there must be no clause in the credit derivative contract outside the direct control of the ADI and the credit events specified in the contract that could prevent the protection seller from being obliged to pay out in a timely manner in the event that the obligor to the underlying exposure fails to make the due payment(s).
27. Where the credit derivative being used for credit risk mitigation purposes is based on cash settlement, eligibility for capital relief requires that the ADI has in place a robust valuation process in order to estimate reliably credit losses on the reference obligation specified in the credit derivative contract, including a defined period for obtaining post-credit event valuations of the reference obligation.
28. Where an ADI purchases credit protection and an existing credit exposure of the ADI is the deliverable obligation under the credit derivative contract, eligibility for capital relief requires that the terms of the underlying exposure must allow for its transfer to the protection seller.⁷⁴ If the protection purchaser's right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.
29. In order to be recognised as credit risk mitigation for capital adequacy purposes, the credit derivative contract must identify clearly those parties responsible for determining whether a credit event has occurred. This determination must not be the sole responsibility of the protection seller. An ADI buying the credit protection must have the right to inform the protection seller of the occurrence of a credit event.

Pools of credit risk mitigation

30. Where an ADI has multiple sources of credit risk mitigation covering a single underlying exposure (e.g. where both a credit derivative and a guarantee partially cover an underlying exposure), the ADI must divide the underlying exposure into portions covered by each type of credit risk mitigation. The risk-weighting of each portion must be calculated separately. Where credit

⁷³ Note that the irrevocability condition does not require that the credit derivative and the exposure be maturity matched; rather that the maturity agreed *ex ante* may not be reduced *ex post* by the protection provider. Paragraph 17 of this Attachment sets out the treatment of call options in determining remaining maturity for credit protection.

⁷⁴ An exception applies where there is a restriction on the transfer of the existing credit exposure and this restriction only applies in the event of restructuring. In this case the limit described in paragraph 9 of this Attachment applies as if restructuring of the underlying exposure was not included within the terms of the credit derivatives contract.

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protection provided by a single protection seller has different maturities (refer to paragraph 17 of this Attachment), these must also be divided into separate portions.

Proportional cover

31. Where there is partial coverage of an underlying exposure by a credit derivative and the protected and unprotected portions are of equal seniority (i.e. the ADI buying credit protection and the protection seller share losses on a pro-rata basis), capital relief will be afforded on a proportional basis. This means that the protected portion of the underlying exposure will receive the capital treatment applicable to eligible credit derivatives with the remainder treated as unprotected.

Tranched cover

32. Where there is partial coverage of an underlying exposure by a credit derivative and there is a difference in seniority between protected and unprotected tranches, the securitisation rules detailed in APS 120 will apply. The exception to this is where an ADI has deducted from capital a materiality threshold as detailed in paragraph 13 of this Attachment.

Credit-default and total-rate-of-return swaps

33. Where credit protection is purchased using a credit-default swap referenced to a single reference entity or a total-rate-of-return swap, that portion of the underlying exposure protected by the credit derivative (or the amount of credit protection purchased as detailed in paragraph 13 of this Attachment) may be weighted according to the risk-weight of the protection seller.

Cash-funded credit-linked notes

34. Where credit protection is purchased using a credit-linked note that is funded by cash, the note issued by an ADI must be treated for capital adequacy purposes as a cash-collateralised transaction, subject to the ADI satisfying the requirements for cash-collateralised as set out in Attachments J, K, and L.

First-to-default basket credit derivatives

35. Where an ADI has purchased credit protection using a credit derivative that is referenced to more than one reference entity and that protection terminates after a credit event occurs on one of those entities (i.e. a first-to-default basket product), protection must only be recognised against the reference entity with the lowest risk-weighted amount. In this case, that portion of the relevant exposure protected by the credit derivative (or the amount of credit protection purchased as detailed in paragraph 15 of this Attachment) may be weighted according to the risk-weight of the protection seller.

DRAFT**Second-to-default basket credit derivatives**

36. Where an ADI has purchased credit protection using a credit derivative that is referenced to more than one reference entity and that protection is triggered after a second credit event occurs on one of those entities (i.e. a second-to-default basket product), protection must only be recognised if the ADI has also purchased first-to-default credit protection or after a first-to-default credit event has occurred on one of the entities in the basket. In this case, the treatment is the same as for first-to-default credit derivatives detailed in paragraph 35 of this Attachment.

Maturity mismatches

37. A **maturity mismatch** exists where an ADI has purchased credit protection using a credit derivative and the residual maturity of the credit derivative contract is less than the residual maturity of the underlying exposure (refer to paragraphs 16 to 17 of this Attachment for the definition of maturity of the underlying exposure and the credit derivative).
38. Where there is a maturity mismatch, a credit derivative will only be recognised for credit risk mitigation purposes when the original maturity of the credit derivative is greater than or equal to 12 months. Credit derivatives with an original maturity of less than 12 months will not be eligible unless the term of the credit derivative exactly matches the maturity of the underlying exposure. In all cases where there is a maturity mismatch, a credit derivative will not be eligible for credit risk mitigation purposes when the term has a residual maturity of three months or less.
39. Where there is a maturity mismatch and the credit derivative has an original maturity of 12 months or more, the amount of credit protection must be adjusted by the following factor to reflect the maturity mismatch:

$$P_a = P \times (t-0.25)/(T-0.25)$$

where:

P_a = value of the amount of credit protection adjusted for maturity mismatch

P = amount of credit protection adjusted for any haircuts (in which case, $P = G_A$ as determined in paragraph 40 of this Attachment)

t = min (T, residual maturity of the credit derivative) expressed in years

T = min (5, residual maturity of the underlying exposure) expressed in years

Currency mismatches

40. A **currency mismatch** exists where an ADI has purchased credit protection using a credit derivative and the credit derivative is denominated in a different currency from that in which the underlying exposure is denominated. In this

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case, the amount of the exposure deemed to be protected (G_A) will be reduced by the application of an adjustment or haircut (H_{FX}) as follows:

$$G_A = G \times (1 - H_{FX})$$

where:

G = nominal amount of the credit derivative

H_{FX} = haircut appropriate for the currency mismatch between the credit derivative and the underlying exposure

41. The haircut for the currency mismatch (H_{FX} in the formula in paragraph 40 of this Attachment) is the same as that applied in paragraph 9 of Attachment M. If an ADI generally uses the comprehensive approach to credit risk mitigation and it uses the standard supervisory haircuts, the haircut to be applied for a currency mismatch will be eight per cent (assuming daily marking-to-market). If an ADI generally uses the comprehensive approach to credit risk mitigation and it uses own-estimate haircuts, the estimates for a currency mismatch must be based on a 10 business day holding period. If an ADI generally uses the simple approach to credit risk mitigation, it may use the standard supervisory haircut of eight per cent for the currency mismatch (assuming daily marking-to-market) or own-estimate haircuts based on a 10 business day holding period.
42. Using the formula detailed in paragraph 22 of Attachment O, haircuts must be scaled up depending on the actual frequency of revaluation of the currency mismatch.

Credit derivatives used for acquiring credit risk exposure

43. An ADI that sells credit protection that is not detailed in paragraphs 44 to 48 of this Attachment must, prior to executing the documentation relating to the sale of that credit protection, obtain APRA's written approval regarding the appropriate regulatory capital treatment for the transaction.

Credit-default swaps

44. Where credit protection is sold via a credit-default swap referenced to a single reference entity, the ADI acquires an exposure to the credit risk of that entity. The risk-weight that must be applied to the exposure is the risk-weight that would otherwise apply to the reference entity. The amount of the exposure is the maximum possible amount payable under the terms of the credit derivative contract if a credit event were to occur.

Total-rate-of-return swaps

45. Credit protection sold via a total-rate-of-return swap must be included in an ADI's trading book.

DRAFT**Cash-funded credit-linked notes**

46. Where credit protection is sold via a cash-funded credit-linked note, the ADI acquires an exposure to both the protection buyer and the entity where the cash collateral is held, with the amount of the exposure being the face value of the note. Where the credit-linked note is structured such that the protection seller receives some percentage of the note's face value if the credit derivative is triggered, the amount of exposure to the reference entity is the difference between the face value and this percentage amount. To account for this exposure, the higher of the risk-weights applicable to the protection buyer and the entity where the cash collateral is held must be applied to the exposure.

First-to-default basket credit derivatives

47. Where an ADI has sold credit protection using a first-to-default basket product, capital must be held against all the reference entities in the basket. The risk-weighted exposure arising from the credit derivative must be calculated as the sum of the individual risk-weighted exposures in the basket, with the amount of capital held capped at the nominal amount of the credit protection provided by the credit derivative. The exception to this requirement is where the first-to-default basket product has an external credit assessment⁷⁵ from an eligible credit assessment institution. In this case, the risk-weight applied will be that applicable to an equivalently rated securitisation tranche (refer to APS 120).

Second-to-default basket credit derivatives

48. Where an ADI has sold credit protection using a second-to-default basket product, capital must be held against all the reference entities in the basket except for the entity that has the lowest corresponding risk-weighted exposure. The risk-weighted exposure arising from the credit derivative will be the sum of the individual risk-weighted exposures in the basket, excluding the lowest risk-weighted exposure amount, with the amount of capital held capped at the nominal amount of the protection provided by the credit derivative.

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Refer to Attachment D.

DRAFT**Attachment Q****Netting****Use of netting**

1. An ADI may, for capital adequacy purposes, net (i.e. through close-out netting or netting by novation) the following types of transactions, subject to the requirements of this Attachment:
 - (a) on-balance sheet loans and deposits where:
 - (i) the ADI is able to determine, at all times, the assets and liabilities of the counterparty that are subject to the netting agreement; and
 - (ii) deposits meet the criteria for eligible financial collateral as set out in this Prudential Standard.
 - (b) OTC derivative transactions (across both the banking and trading books) with a single counterparty. This may include netting across different market-related product types, such as credit derivatives, to the extent that they are recognised as market-related transactions for capital adequacy purposes.⁷⁶ An ADI may not, however, recognise payments netting; and
 - (c) securities financing transactions.
2. At Level 1, an ADI may only net transactions with related entities if the transactions comply with the requirements in this Attachment.
3. At Level 2, an ADI may only include netting transactions undertaken by an individual member of a consolidated group if the netting transactions comply with the requirements for netting as set out in this Attachment.
4. An ADI that chooses to net transactions must continue to do so and must apply netting to all transactions in both the banking and trading book covered by a netting agreement.
5. An ADI may only net positions across the banking and trading book if the netted transactions:
 - (a) are marked-to-market daily, where applicable; and
 - (b) the collateral instruments used in the transactions comply with the criteria for eligible collateral in the banking book.

⁷⁶ For the purposes of this Attachment securities financing transactions are not included as part of market-related transactions.

DRAFT**Definitions**

6. For the purposes of this Attachment the following definitions apply:

- (a) **close-out netting** – the process of combining all outstanding transactions and reducing them to a single net payment in the event of default of a counterparty to a netting agreement. There are two stages to this process:
 - (i) fixing of obligations on the occurrence of an event; and
 - (ii) calculating the cost to each party in closing out transactions according to a prescribed formula.

The amounts due to both counterparties may be calculated in a single currency, or converted to a single currency, and then netted to a single payment due by one party to the other;

- (b) **netting** – the process under a netting agreement of combining all relevant outstanding transactions between two counterparties and reducing them to a single net sum for a party to either pay or receive;
- (c) **netting agreement** – has the meaning given in paragraph 7 of this Attachment;
- (d) **netting by novation** – where a netting agreement exists between two counterparties under which any obligation between the parties to deliver a given currency (or equity or debt instrument or commodity) on a given date is automatically amalgamated with all other obligations under the netting agreement for the same currency (pairs) and value date. The result is to legally substitute a single net amount for the previous gross obligations;
- (e) **on-balance sheet netting** – where a netting agreement covering loans and deposits exists under which obligations between the parties are determined on a net basis. Loans are to be treated as an exposure and deposits with a lending ADI subject to on-balance sheet netting are to be treated as cash collateral as defined in Attachments J and K;
- (f) **OTC derivative transaction** – a customised, privately negotiated, risk-shifting agreement, the value of which is derived from the value of an underlying asset;
- (g) **payments netting** – a process designed to reduce operational costs and risks associated with daily settlement of transactions and is not of itself recognised for capital adequacy purposes as an ADI's credit risk arising from a counterparty's gross obligations to the ADI is not in any way affected by payments netting;
- (h) **roll-off risk** – the risk of a sudden material increase in an exposure(s) when short-term obligations that have been netted against longer term claims either mature, are rescinded or are generally no longer available to offset the obligation;

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- (i) **securities financing transactions** – transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing transactions where the value of the transactions depends on the market valuations of securities and the transactions are typically subject to margin agreements; and
- (j) **walkaway clause** – a provision which permits a non-defaulting counterparty to make only limited payments, or no payments at all, to a defaulting party, even if the defaulting party is a net creditor.

Eligible bilateral netting agreements

7. An ADI may only net, for capital adequacy purposes, claims and obligations with a counterparty that are covered by a legally binding eligible bilateral netting agreement (including a master agreement) (**netting agreement**), if the netting agreement:
 - (a) is in writing;
 - (b) creates a single legal obligation covering all transactions and collateral included in the netting agreement, such that the ADI would have the right to:
 - (i) terminate and close-out, in a timely manner, all transactions under the netting agreement;
 - (ii) net gains and losses on transactions, including the value of any collateral, terminated and closed out under the netting agreement so that the ADI would have either a claim to receive or an obligation to pay only the net sum of the close-out values of individual transaction. For forwards, swaps, options and similar derivative contracts, this will include the positive and negative mark-to-market values of individual transactions; and
 - (iii) liquidate or set-off collateral

in the event that either party fails to perform due to default, liquidation or bankruptcy or other similar circumstances;⁷⁷
 - (c) is supported by a written and reasoned legal opinion that concludes that in the event of default, liquidation, bankruptcy or other similar circumstances of a party to a netting agreement, the relevant courts and authorities would find the ADI's claims and obligations are limited to the single net sum determined in the netting agreement under:

⁷⁷ In some countries there are provisions for the authorities to appoint an administrator/conservator to a troubled bank. Under statutory provisions applying in those countries, the appointment of an administrator may not constitute grounds for the triggering of netting agreements. Such provisions do not prevent the recognition of affected netting agreements for the purposes of these guidelines provided that a netting agreement can still take effect in the event the bank under administration does not meet its obligations under transactions as they fall due.

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- (i) the law of the jurisdiction in which the counterparty is incorporated or formed (or, in the case of a natural person, resides), and if a foreign branch of the counterparty is involved, the law of the jurisdiction in which the branch is located;
- (ii) the law that governs the individual transactions involved;
- (iii) the law that governs any contract or agreement necessary to give effect to the netting;

and, in particular, in the insolvency or external administration of the counterparty, the netting will be recognised under those laws, so that it will not be possible for the liquidator or other external administrator of the counterparty to claim a gross amount due from the ADI while only being liable to pay a dividend in insolvency to the ADI (as separate money flows); and

- (d) is not subject to a walkaway clause.

Legal opinion

8. An ADI that has obtained a positive legal opinion about the enforceability of a netting agreement must:
 - (a) ensure that the legal opinion is not subject to assumptions or qualifications that are unduly restrictive;
 - (b) review assumptions regarding the enforceability of the netting agreement and ensure they are specific, factual and adequately explained in the opinion; and
 - (c) review and assess all assumptions, qualifications and omissions in a legal opinion on the netting agreement to determine whether they give rise to any doubt about the enforceability of the netting agreement.
9. A legal opinion may be obtained on a group basis, and an individual member of the consolidated banking group may rely on the opinion for the purposes of this Attachment. This is provided the ADI and the individual group member have satisfied themselves as to the application of the legal opinion to a netting agreement to which the group member is a counterparty.
10. An ADI must not recognise a netting agreement, for capital adequacy purposes, if there is any doubt as to the enforceability of the netting agreement.
11. An ADI may rely on a general legal opinion about the enforceability of a netting agreement in a particular jurisdiction if the ADI has determined that the type of netting agreement involved is encompassed by the general legal opinion.
12. An ADI must satisfy itself that a netting agreement and supporting general legal opinion are applicable to each counterparty, transaction and product type

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undertaken with the counterparty and in all jurisdictions where transactions are originated.

Policies, systems and controls

13. An ADI must have a netting policy, approved by the Board, that sets out its approach to netting and, as a minimum, addresses the requirements of this Attachment.
14. An ADI's netting policy must include systems and controls for monitoring netting agreements, including monitoring and managing:
 - (a) roll-off risk;
 - (b) relevant exposures on a net basis; and
 - (c) termination riskfor all transactions subject to netting.
15. An ADI must have appropriate systems and controls to be able to monitor and report netted transactions on a gross and net basis.
16. An ADI must have internal procedures to verify that a transaction which is netted is covered by an appropriate legal opinion which satisfies the requirements of this Attachment.
17. An ADI must be able to demonstrate to APRA, if required, the satisfactory application of its netting policy, including netting systems and controls, and must provide details of the policy to APRA if requested to do so.

Monitoring and reporting of netting agreements

18. An ADI that nets transactions for capital adequacy purposes must maintain adequate records to support the application of the netting agreement.
19. An ADI must exclude netted transactions for which it has not obtained a satisfactory legal opinion in a specific jurisdiction, when determining the net sum due to/from the counterparty involved. Excluded transactions must be reported on a gross basis. The ADI may, however, continue to net other transactions that originate in jurisdictions where it has obtained a positive legal opinion about the enforceability of a netting agreement.
20. An ADI that becomes aware that a regulator or supervisor of a counterparty has given notice that it is not satisfied that netting is enforceable under the laws of the regulator's or supervisor's home country must not recognise the netting agreement for capital adequacy purposes regardless of any legal opinion obtained by the ADI.
21. An ADI must have procedures in place to monitor legal developments to ensure that netting agreements continue to be legally enforceable. The ADI must

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update its legal opinion covering netting agreements, as necessary, to ensure the continued enforceability of a netting agreement.

22. An ADI must report transactions on a gross basis if legal developments affect the enforceability of a netting agreement.

Collateral and guarantees

23. An ADI may take into account collateral and guarantees when calculating the risk-weight to be applied to the net sum calculated under a netting agreement. An ADI may only assign a risk-weight based on collateral and guarantees if the collateral or guarantees have been posted or are otherwise subject to a legally enforceable agreement and are legally available for all individual transactions making up the net sum of exposures involved.
24. An ADI that has a netting agreement with a counterparty that contains provisions for applying collateral or guarantees to netted exposures outstanding between the ADI and the counterparty, must ensure that the provisions comply with the requirements set out in Attachment N with respect to eligible collateral and guarantees.

Calculation of exposure: On-balance sheet netting transactions

25. An ADI that satisfies the requirements of this Attachment for on-balance sheet netting must use the formula in paragraph 7 of Attachment O to calculate its net on-balance sheet exposure for capital adequacy purposes. This includes using a zero haircut in this formula except when a currency mismatch exists. The ADI must also apply a 10 business day holding period when daily mark-to-market is conducted and satisfy paragraphs 11 and 25 to 30 of Attachment O.

Calculation of exposure: OTC derivatives

26. An ADI that satisfies the requirements in this Attachment for netting may report, for capital adequacy, purposes OTC derivative transactions (in both the banking and trading book) on a net basis and calculate the credit equivalent amount of these transactions in accordance with the methodology outlined below.

Credit equivalent amount

27. An ADI must use the current exposure method to calculate the exposure for OTC derivative transactions that fall under netting agreements for capital adequacy purposes.
28. The credit equivalent amount (**CEA**) of transactions subject to a netting agreement must be calculated as the sum of the net current credit exposure (**NCCE**) (i.e. net mark-to-market replacement cost) of all transactions covered by the netting agreement, if positive, plus an add-on (**PFCE_{adj}**) for potential future credit exposure based on the notional principal of all the individual

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underlying contracts (i.e. the gross potential future credit exposure) adjusted to reflect the effects of the netting agreement. Thus:

$$\text{CEA} = \text{NCCE (if positive)} + \text{PFCE}_{\text{adj}}$$

Net current credit exposure

29. NCCE is the sum of all positive and negative mark-to-market values of all individual contracts covered by a netting agreement (i.e. positive mark-to-market values of transactions may be offset against negative mark-to-market values on other transactions covered by the netting agreement). If the net sum of individual mark-to-market values is positive, the NCCE is equal to that sum. If the sum of mark-to-market values is zero or negative, the NCCE is set equal to zero.

Potential future credit exposure

30. An ADI must recognise the effects of netting agreements on its potential future credit exposure by applying the formula below to produce an adjusted add-on amount for potential future credit exposure on all contracts subject to the netting agreement (**PFCE_{adj}**). Thus:

$$\text{PFCE}_{\text{adj}} = 0.4(\text{PFCE}_{\text{gross}}) + 0.6 (\text{NGR} \times \text{PFCE}_{\text{gross}})$$

31. The potential future credit exposure (**PFCE_{gross}**) is calculated as the sum of an ADI's potential future credit exposure for each individual transaction covered by a netting agreement with a counterparty as if no netting would occur (with the exception of transactions covered by paragraph 29 of this Attachment). Potential future credit exposure for each transaction is calculated by multiplying the notional principal amount of the transaction by the appropriate credit conversion factor for that transaction as set out in Attachment I.
32. For the purpose of calculating **PFCE_{gross}**, an ADI may treat matching transactions included in a netting agreement as a single transaction with a notional principal equivalent to the net receipts on those transactions. For this purpose, matching transactions are defined as forward foreign exchange and other similar market-related transactions in which the notional principal is equivalent to cash flows, where the cash flows fall due on the same value date and are in the same currency.
33. The net to gross ratio (**NGR**) is the ratio of the net current exposure of all transactions included in a netting agreement to the gross current credit exposure (**GCCE**) of these same transactions. GCCE is the sum of the mark-to-market values of all transactions covered by a netting agreement with a positive mark-to-market value with no offsetting against contracts with a negative mark-to-market value (with the exception of transactions covered by paragraph 29 of this Attachment). The NGR reflects the risk reducing portfolio effects of netted transactions with respect to current credit exposure. Thus:

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$$\text{NGR} = \text{NCCE}/\text{GCCE}$$

34. The NGR may be calculated using one of the following approaches:
- (a) **counterparty-by-counterparty approach** – under this approach a unique NGR is applied to each counterparty in calculating the CEA of transactions with that counterparty. NGR is defined as the NCCE of all transactions with an individual counterparty covered by a netting agreement (i.e. $\text{NCCE}_{\text{individual}}$) divided by the GCCE of all the transactions with that counterparty covered by the netting agreement (i.e. $\text{GCCE}_{\text{individual}}$). In calculating $\text{GCCE}_{\text{individual}}$, negative mark-to-market values for individual transactions with the same counterparty may not be used to offset positive mark-to-market values for other transactions with the same counterparty; or
 - (b) **aggregate approach** – under this approach a single NGR is calculated and applied to all counterparties in calculating the CEA for transactions with each of those counterparties. The NGR is the ratio of the sum of all NCCEs of all transactions with all counterparties subject to any netting agreement (i.e. $\text{NCCE}_{\text{aggregate}}$) to the sum of all of the GCCEs for all transactions of all counterparties subject to any netting agreement (i.e. $\text{GCCE}_{\text{aggregate}}$). In calculating $\text{GCCE}_{\text{aggregate}}$, negative mark-to-market values of transactions with one counterparty cannot be used to offset positive mark-to-market values of transactions with that counterparty or any other counterparty included in the aggregate calculations.
35. An ADI must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR and must inform APRA of which approach it intends to use.

Other criteria

36. An ADI may at Level 1 and Level 2, with APRA's written approval, elect to include foreign exchange contracts with an original maturity of fourteen calendar days or less with other transactions in calculating netted exposures. Where an ADI chooses to include such contracts, it must do so for all counterparties for whom it calculates net exposures. An ADI cannot selectively include such contracts in calculating net exposures. All such foreign exchange contracts must be included in calculating current credit exposures and potential future credit exposures (with a credit conversion factor of 1.0%).
37. An ADI must exclude from netting market-related instruments traded on recognised exchanges, where they are subject to daily margining requirements.

Risk-weighted amount

38. With respect to the netted exposures determined in paragraphs 26 to 37 of this Attachment, an ADI must assign the relevant risk-weight applicable to a counterparty, or if eligible, the risk-weight of a guarantor or collateral to the CEA.

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39. For the purposes of paragraph 8 of Attachment O, potential future exposure is $PFCE_{adj}$ as determined in paragraph 30 of this Attachment.

Calculation of exposure: Securities financing transactions*Comprehensive approach*

40. An ADI, that uses that uses the comprehensive approach to credit risk mitigation must apply the following formula for the purposes of calculating the ADI's adjusted exposure (E^*) amount after netting for securities financing transactions, unless it chooses to use a VaR models approach in accordance with paragraph 42 of this Attachment.

$$E^* = \max \{0, [(\Sigma(E) - \Sigma(C)) + \Sigma (E_s \times H_s) + \Sigma (E_{fx} \times H_{fx})]\}$$

where:

E^* = the exposure value after risk mitigation

E = current value of the exposure

C = the value of the collateral received

E_s = absolute value of the net position in a given security

H_s = haircut appropriate to E_s

E_{fx} = absolute value of the net position in a currency different from the settlement currency

H_{fx} = haircut appropriate for currency mismatch

The “ Σ ” symbol applied to a values means the summation of all such values under the netting agreement.

41. An ADI must multiply the net long or short position of each security included in the netting agreement by the appropriate haircut. The ADI must also apply the rules in paragraph 7 of Attachment N and paragraphs 7 to 30 of Attachment O regarding the calculation of haircuts.

VaR models approach

42. An ADI that wishes to use a VaR model to determine its net securities financing transaction exposure for capital adequacy purposes must seek explicit approval to do so from APRA. If approved, the VaR model may be used for securities financing transactions covered by netting agreements on a counterparty-by-counterparty basis.
43. An ADI's VaR model used to determine the ADI's net securities financing transaction exposure for capital adequacy purposes must provide daily estimates of the 99th percentile, one-tailed confidence interval of the potential change in value of the unsecured exposure amount ($\Sigma E - \Sigma C$), and satisfy the General

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Criteria, Qualitative Standards and Quantitative Standards for recognition of internal models in APS 116, other than the requirement for a 10 day holding period listed therein. The minimum holding period is five days, and the ADI must adjust upwards the minimum holding periods for market instruments where such a holding period would be inappropriate given the liquidity of the instrument concerned.

44. An ADI using the VaR model approach to determine its net securities financing transaction exposure for capital adequacy purposes must use the formula below to calculate its exposure (E^*):

$$E^* = \max \{0, [(\Sigma E - \Sigma C) + \text{VaR output from internal model}]\}$$

where symbols are as defined in paragraph 40 of this Attachment. ADI's using the VaR models approach must use the previous business day's model output when calculating its regulatory capital requirement.