



Response to Submissions

Implementation of the Basel II Capital Framework

4. Standardised approaches to credit risk and operational risk

31 July 2007

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Preamble

This paper discusses APRA's responses to submissions on its proposals for the use of the standardised approaches under the Basel II Framework by authorised deposit-taking institutions (ADIs). The paper addresses:

- credit risk (first release of the draft *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) in April 2005); and
- operational risk (first release of the draft *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk* (APS 114) in July 2005).

Final drafts of APS 112 and APS 114 have been released with this paper. These refine APRA's proposals and incorporate a number of amendments suggested in the consultation process. APRA has also undertaken a survey of the impact of the standardised approaches, which has assisted APRA in its review of the draft prudential standards and the submissions received.

The Basel II prudential standards will be finalised in late 2007 for implementation on 1 January 2008.

Written submissions on these final draft standards should be forwarded to APRA by 3 September 2007 to:

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Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

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Chapter 1 – Standardised approach to credit risk

Review of submissions

APRA received 11 submissions on the first draft of *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112). This chapter examines the main issues raised and APRA's response in each area. It also addresses issues raised through other channels.

Risk-weights for residential mortgage loans

The issues

APRA proposed a risk-weighting scheme for residential mortgage loans consisting of four different risk-weights based on the loan-to-valuation ratio (LVR) of a loan, whether the loan has acceptable lenders mortgage insurance and whether the loan is a 'standard' or 'non-standard' housing loan. APRA also proposed that capital concessions associated with mortgage insurance cover require, at a minimum, the first 40 per cent of a loan to be insured by an acceptable lenders mortgage insurer.

Comments received

A number of issues were raised in submissions regarding the following:

- the risk-weighting of mortgage insured loans;
- the proposed threshold level of 40 per cent cover that would apply to mortgage insured loans;
- the treatment of non-standard loans;
- the overall LVR-based approach to allocating risk-weights to individual loans; and
- the extent of departure from a flat 35 per cent risk-weighting for housing loans.

APRA's prudential approach

APRA's approach seeks to achieve the Basel II Framework's overall objective of greater risk sensitivity while applying the new concessionary risk-weight of 35 per cent for housing loans in accordance with strict prudential criteria.

In its April 2005 discussion paper, APRA highlighted the advantages of its proposed approach in terms of:

- more closely aligning regulatory capital requirements to the relative riskiness of particular housing loan types;
- providing greater incentives for improved risk management practices;
- avoiding any potential regulatory distortions that could arise under alternative risk-weighting schemes; and
- ensuring an appropriate level of overall system capital, taking ADIs and lenders mortgage insurers together, to support residential mortgage lending.

These advantages remain valid.

Because of the differences in regulatory capital requirements for housing lending between ADIs and lenders mortgage insurers, APRA's proposed risk-weighting scheme will result in a modest reduction in total system capital held against housing loans. APRA believes that some reduction can be justified on the basis that lenders mortgage insurers, despite their mono-line status, provide international diversification of housing loan risk and a 'second pair of eyes' on credit assessment by ADIs. However, APRA could not see a case, on public policy grounds, to accept a significantly larger reduction in total system capital that would result from alternative risk-weighting schemes proposed in some submissions.

Accordingly, APRA has retained its proposed risk-weighting scheme for residential mortgage loans.

Risk-weights for past due or impaired residential mortgage loans

The issues

In the first draft APS 112, APRA proposed that loans and claims secured against eligible residential mortgages that are past due for more than 90 days and/or impaired (refer to *Prudential Standard APS 220 Credit Quality* for the definition of '90 days past due' and 'impaired') should attract a risk-weighting of 100 per cent. This approach did not differentiate between loans covered by acceptable lenders mortgage insurers and loans without such cover.

Comments received

Submissions questioned whether APRA's approach might be too rigid and give insufficient emphasis to the role that lenders mortgage insurance plays in potentially reducing an ADI's exposure to loss on defaulted loans.

APRA's prudential approach

APRA acknowledges this argument. In the final draft APS 112, the risk-weighting treatment of past due or impaired residential mortgage loans differs depending on whether or not the loans are covered by acceptable lenders mortgage insurance.

APRA's approach to the risk-weighting of residential mortgage loans recognises the risk mitigation provided by lenders mortgage insurers, which continues when a housing loan with mortgage insurance becomes past due more than 90 days and/or impaired. However, consistent with its general approach that ADIs must safeguard against risk concentrations and large exposures, APRA believes there are strong prudential reasons for a 'cap' on the risk mitigation it can accept in respect of such loans.

In the final draft APS 112, the risk-weights of loans and claims secured against eligible residential mortgages that are insured with an acceptable lenders mortgage insurer that become past due for more than 90 days and/or impaired do not change from their original risk-weight. This is subject to the requirement that the total of such loans covered by each single lenders mortgage insurer does not exceed the ADI's large exposures limit (refer to *Prudential Standard APS 221 Large Exposures*). All other loans and claims secured against eligible residential mortgages that are past due for more than 90 days and/or impaired, including those mortgage insured loans in excess of the ADI's large exposures limit, will attract a risk-weight of 100 per cent.

Comparable prudential regulation of offshore lenders mortgage insurers

The issues

The first draft APS 112 proposed the requirement that any offshore entities offering lenders mortgage insurance to borrowers in Australia be subject to 'comparable prudential regulation' in their home jurisdiction.

In May 2007, the Government announced that it would amend the *Insurance Act 1973* to require all direct offshore foreign insurers (DOFIs) to be authorised by APRA to carry on insurance business in Australia.

APRA's prudential approach

In the light of Government policy, the 'comparable prudential regulation' requirement can be substituted by a simple requirement that lenders mortgage insurers must be regulated by APRA. Hence, the final draft APS 112 proposes that, for an ADI's mortgage insurance cover to be 'acceptable' for the purpose of attracting the risk-weights that apply to mortgage insured loans:

- the lenders mortgage insurer must be regulated by APRA for the purpose of Level 1 regulatory capital requirements; and
- in the case of overseas subsidiaries of Australian banks, for the purpose of Level 2 regulatory capital requirements, APRA will accept the host supervisors' rules on what are acceptable lenders mortgage insurers in their jurisdictions.

Risk-weights for 'other retail' exposures

The issues

In its April 2005 discussion paper, APRA proposed retaining the existing 100 per cent risk-weight for 'other retail' exposures rather than adopt the 75 per cent risk-weight allowed in the Basel II Framework's standardised approach to credit risk.

Comments received

Some submissions claimed that APRA's proposed departure from the Basel II Framework could be a source of competitive disadvantage between the standardised and internal ratings-based (IRB) institutions.

APRA's prudential approach

When releasing its draft proposals, APRA observed that the results of quantitative impact studies undertaken by the larger Australian banks suggested that a 75 per cent risk-weight would offer Australian ADIs an inadequate buffer for the other risks captured under the more sophisticated approaches but not under the standardised approach. More recent modelling by the same banks confirms that a 75 per cent risk-weight in the Australian market may not fully capture credit risks, let alone provide a buffer.

In light of these results, APRA has retained the proposed 100 per cent risk-weight for other retail exposures.

Risk-weights for exposures to ADIs

The issues

The Basel II Framework allows national supervisors an option either to:

- apply a flat risk-weighting to all ADIs incorporated in a given country that is one category less favourable than that assigned to claims on the sovereign of that country; or
- base the risk-weighting on the external credit assessment of the ADI itself with claims on unrated ADIs being risk-weighted at 50 per cent.

APRA proposed to adopt the second option. If an ADI holds an exposure that has been issued or written by an unrated ADI, the risk-weight for that exposure would be 50 per cent or, in most cases, 20 per cent if the original maturity is three months or less.

Comments received

In line with submissions received at the time the Basel II Framework was released, several submissions raised concerns about the competitive impact of APRA's approach.

APRA's prudential approach

APRA remains of the view that the second option is clearly more consistent with the overall Basel II Framework's objective of enhancing the risk sensitivity of regulatory capital. Accordingly, the final draft APS 112 retains the requirement that risk-weights for exposures to ADIs be linked to their external risk grades.

Risk-weights for 'higher risk' exposures

The issues

The Basel II Framework provides a risk-weighting of 150 per cent (or higher) for certain risk categories denoted as higher risk. It further states that national supervisors may decide to apply a 150 per cent (or higher) risk-weight reflecting the higher risks associated with some other assets, such as venture capital and private equity investments.

In its April 2005 discussion paper, APRA identified listed equities and unlisted equities as higher risk exposures and proposed that these types of exposures be risk-weighted at 300 per cent and 400 per cent, respectively.

Comments received

Some responses expressed concern that this proposed treatment had the potential to discourage desirable venture capital transactions and strategic investments.

APRA's prudential approach

APRA's proposed approach reflects the different risks faced by an ADI engaging in equity-type investment activities compared with traditional banking and related activities. The approach is consistent with the Basel II Framework's intent that higher risk activities should be identified by national supervisors and risk-weighted accordingly. The approach is also consistent with APRA's proposed treatment of equity exposures in the banking book by ADIs adopting the IRB approaches.

Accordingly, the final draft APS 112 retains the requirement that listed equities be risk-weighted at 300 per cent and unlisted equities at 400 per cent.

Additions and other changes

The final draft APS 112 substantially completes the release of APRA's proposals on the implementation of the Basel II Framework's standardised approach to credit risk. Material that is new to this draft includes the following:

- the proposed treatment of credit derivatives in the banking book. This was released on 13 November 2006 and, after minor amendments in response to industry feedback and internal review, has now been incorporated into the draft standard;
- the regulatory capital requirements for failed foreign exchange and securities transactions;
- criteria to be used for assessing the recognition of clearing organisations and exchanges; and
- the treatment of counterparty credit risk has been dealt with more specifically as part of the requirements for credit risk-weighting of off-balance sheet credit exposures.

Minor language and other changes have also been made in the interests of greater clarity or consistency. The format of the standard has also been revised to conform to APRA's current style of prudential standard. This is an interim step and a more comprehensive review of the format will be carried out prior to the finalisation of APS 112 (see below).

Outstanding issues

The following issues for APS 112 remain outstanding:

- the treatment of margin lending. Both the standardised and IRB approaches to credit risk typically result in a zero regulatory capital requirement for ADIs' margin lending exposures. APRA does not regard this as an appropriate outcome. APRA is developing a more suitable approach on which it will seek industry views;
- the requirements for recognition of external credit assessment institutions (ECAI). APRA's approach will be released shortly. The mapping of ECAI ratings to risk-weights, as detailed in the final draft APS 112, will be reviewed once the ECAI recognition criteria are finalised; and
- the format of APS 112. APRA acknowledges the level of detail in APS 112 and the length of the standard. During this current consultation period, APRA will fully review the 'language' of the standard, opportunities to make it more principles based and the possibility of moving some of the material to a prudential practice guide (PPG).

Chapter 2 – Standardised approach to operational risk

Review of submissions

APRA received 10 submissions on the first draft of *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk (APS 114)*. This chapter examines the main issues raised and APRA's response in each area. It also addresses issues raised through other channels.

'Gross income' terminology

The issues

The Basel II Framework uses the terminology 'gross income' – defined as net interest income plus net non-interest income – as the proxy indicator for the non-retail/commercial business line (i.e. APRA's 'all other activity area of business'). In the first draft APS 114, APRA adopted the term 'net income' in an attempt to minimise confusion.

Comments received

Based on comments received, and difficulties experienced by some ADIs in calculating the operational risk regulatory capital requirement for the 'all other activity area of business' in the impact survey, it is clear that the terminology creates confusion. This is because the term 'net income' is a term with a widely accepted accounting meaning, which is inconsistent with the definition of the term in the first draft APS 114.

APRA's prudential approach

The final draft APS 114 replaces the term 'net income' with the term 'adjusted gross income'. Since the calculation is primarily a gross income calculation (for the 'all other activity area of business'), using the term 'adjusted gross income' is both accurate and more closely correlated with the Basel II Framework's terminology; in addition, the term does not have an accounting meaning.

Treatment of intra-group dividends and management fees

The issues

The draft APS 114 proposed that certain adjustments be made to reported profit to calculate 'net income' (now called 'adjusted gross income') for the purpose of determining the operational risk charge arising from 'all other areas of business'. No adjustment of intra-group income and expense flows at Level 1 was allowed for in the draft standard.

Comments received

Some submissions argued that the inclusion of intra-group dividends, management fees and cross business line service income in Level 1 net income figures would penalise diversified ADIs. In particular, income from general insurance and wealth management subsidiaries would be double counted where these investments are deducted, for regulatory capital purposes, from an ADI's capital base.

APRA's prudential approach

Intra-group activities raise a number of complex issues and the circumstances can vary considerably between transactions and between institutions. Nonetheless, APRA must apply its requirements consistently across the ADI industry.

In many instances, operational risk would be associated with intra-group payments. In the case of management fees, for example, operational risk is likely to be associated with the services for which the management fees were payable. In addition, what is recouped as management fees in one institution may be recouped as intra-group dividends in another.

On balance, APRA has concluded that all intra-group dividends and management fees should remain part of the income base for the purpose of determining the operational risk regulatory capital requirement at Level 1.

Aggregation of business lines

The issues

The Basel II Framework's standardised approach requires ADI activities to be divided into eight business lines. Within each business line, gross income is used as a proxy to calculate the operational risk exposure and, consequently, the regulatory capital requirement. The alternative standardised approach which APRA intends to adopt attempts to simplify the standardised approach. It allows ADIs to use loans and advances multiplied by a factor (beta) to calculate the operational risk charge for retail and commercial banking activities. Gross income is used for the other six areas of business.

The betas for retail and commercial banking activities are 12 per cent and 15 per cent, respectively. Under the alternative standardised approach, ADIs may elect to aggregate retail and commercial banking but must apply a beta of 15 per cent if they do so.

The first draft APS 114 proposed that ADIs aggregate retail and commercial banking activities into one area of business and apply a beta of 15 per cent to loans and advances in this area. APRA's intention was to keep the calculation of the regulatory capital requirement as simple as possible.

Comments received

Submissions argued that the aggregation of the retail and commercial areas of business would:

- heavily discriminate against those ADIs that have little or no commercial business, which is the majority by number of ADIs adopting the standardised approach; and
- result in a loss in granularity and ignore the relationship between the activity and the level of risk, since it assumes the same level of risk from the two activities.

APRA's prudential approach

APRA acknowledges these arguments; it also notes that the impact survey has shown that the disaggregation of retail and commercial banking activities is unlikely to involve significant computational burden. Accordingly, the final draft APS 114 now proposes three areas of business with a separate beta applying to each, as follows:

- retail banking – beta of 12 per cent;
- commercial banking – beta of 15 per cent; and
- all other activity areas of business – beta of 18 per cent.

Requirement for audited figures

The issues

The first draft APS 114 required the underlying data used in operational risk calculations to be reconciled to the audited year-end and half-year financial statements. The intention was to improve the integrity of data used.

Comments received

A number of submissions raised concerns that audited financial statements are typically not available within the timeframe of 20 business days after each quarter end in which regulatory returns are required to be lodged. Consequently, this requirement could not be met.

APRA's prudential approach

APRA acknowledges these concerns. The final draft APS 114 now proposes that balances of total gross outstanding loans and advances and adjusted gross income must be reconciled on a 'timely basis' with the audited year-end and, where available, half-year financial statements. The inclusion of the words 'timely basis' would enable ADIs to reconcile data after lodgement of APRA regulatory returns and, if necessary, resubmit any returns based on the materiality of any discrepancies identified.

ADIs reporting at Level 2

The issues

The first draft APS 114 defined the term 'loans and advances' for retail and commercial banking activities by reference to APRA's prudential returns.

Comments received

Comments received during the consultation period highlighted that, for those ADIs with Level 2 reporting obligations, the prudential returns do not sufficiently separate retail and commercial exposures at the level required under APS 114, since the returns use an accounting rather than a prudential basis of consolidation. Consequently, amounts reported at Level 2 cannot be referenced to the APRA returns.

APRA's prudential approach

The reporting instructions will provide additional guidance to ADIs regarding the reporting of data at Level 2.

Mapping process to business lines and review of process

The issues

The Basel II Framework specifies that the mapping process to business lines must be subject to independent review. This requirement was reflected in the first draft APS 114.

Comments received

Submissions noted that the draft did not establish a minimum frequency or specify what is considered acceptable in relation to independent review.

APRA's prudential approach

APRA has given further consideration to this issue and has attempted to achieve an appropriate balance between consistency with the Basel II Framework, internal consistency across the entire suite of APRA prudential standards and the objective of applying a principles-based approach to prudential standards.

The final draft APS 114 omits specific references to the documenting and independent review of mapping processes to business lines. APRA is of the view that these requirements are sufficiently dealt with in the more general prudential requirements for ADIs.

Additions and other changes

APRA's review of APS 114 has led to other changes to the draft standard. These are:

- the inclusion of cash in the definition of loans and advances outstanding under the retail banking area of business;
- clarification of the observations used for the operational risk regulatory capital requirement calculation, in the event of a merger between two or more ADIs; and
- the exclusion of income from insurance recoveries from the calculation of adjusted gross income.



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