



Prudential Standard APS 112

Capital Adequacy: Credit Risk

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that all locally incorporated ADIs adopt a uniform approach to the measurement of their on- and off-balance sheet credit exposures for capital adequacy purposes.

This Prudential Standard forms part of a comprehensive set of prudential standards dealing with capital adequacy.

Authority and application

1. This Prudential Standard, made under section 11AF of the *Banking Act 1959* (**the Act**), applies to all authorised deposit-taking institutions (**ADIs**) authorised under the Act. The *Guidance Notes AGN 112.1 Risk-Weighted On-Balance Sheet Credit Exposures (AGN 112.1)*, *AGN 112.2 Risk-Weighted Off-Balance Sheet Credit Exposures (AGN 112.2)*, *AGN 112.3 Netting (AGN 112.3)* and *AGN 112.4 Treatment of Credit Derivatives in the Banking Book (AGN 112.4)* form part of this Prudential Standard.
2. The procedures and requirements set out in this Prudential Standard and the guidance notes attaching to it for calculating an ADI's risk-weighted on- and off-balance sheet credit exposures for capital adequacy purposes are applicable to all locally incorporated ADIs¹ on both a stand-alone and consolidated group basis. Reference to "an ADI" or "ADIs" includes an ADI on a stand-alone basis and the consolidated ADI group.

Risk weighting approach

3. To ensure that all locally incorporated ADIs maintain a minimum level of capital that broadly reflects their credit risk profiles, they must risk-weight their on-balance sheet assets and off-balance sheet business (including both market-related and non-market-related transactions) according to certain risk categories.
4. Each on-balance sheet asset and off-balance sheet transaction is assigned to one of four categories of risk weight – 0, 20, 50 and 100 per cent, based on the riskiness of counterparty default (refer AGN 112.1). All off-balance sheet transactions which give rise to credit risk are converted into on-balance sheet equivalents according to specified credit conversion factors prior to allocating the assigned risk weight (refer AGN 112.2).
5. The risk weights assigned reflect broad judgements of regulators about credit risk on a portfolio basis, and should not be taken as a substitute for individual assessments of credit risks associated with particular exposures. The board of directors and management of an ADI have primary responsibility to ensure that adequate systems are in place to individually assess the credit risk in an ADI's operations, to allocate the appropriate amount of capital to cover that risk and to suitably price the transactions to reflect the risk undertaken.

Netting

6. Subject to APRA-specified requirements for bilateral netting arrangements, an ADI may net off-balance sheet credit exposures arising from market-related contracts with a counterparty that are covered by eligible bilateral netting agreements (refer AGN 112.3).

¹ Foreign ADI as defined in Division 1B of the *Banking Act 1959*.

Collateral and guarantees

7. Although the primary determinant of the risk weight of a particular on- or off-balance sheet transaction is the nature of the underlying counterparty, APRA recognises qualifying collateral (e.g. cash, securities issued by recognised entities and residential mortgages), guarantee arrangements that provide for direct, explicit, irrevocable and unequivocal recourse to the guarantors (refer AGN 112.1) and certain credit derivatives (refer AGN 112.4).
8. An on- or off-balance sheet credit exposure secured against eligible collateral, a guarantee or qualifying credit derivative is assigned a lower risk weight based on the collateral, guarantor or credit derivative counterparty, rather than the counterparty to the transaction.