

Prudential Standard

APS 220 – Credit Quality

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Prudential Standard

APS 220 - Credit Quality

Objective

This standard aims to ensure that all ADIs control credit risk by adopting prudent practices with respect to the measurement and reporting of, and provisioning for, impaired assets. More broadly, it aims to promote the adoption of effective risk grading systems for monitoring asset quality.

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Principles

Overview

1. Credit risk – the risk of counterparty default – usually represents the single largest risk facing an ADI. The presence of a well-functioning credit risk management system is, therefore, fundamental to the safety and soundness of an ADI. It is the responsibility of the board of directors (Board) and management of an ADI to ensure that an effective credit risk management system is in place and is appropriate to the needs of the institution concerned. In general, a credit risk management system should include methodologies with respect to monitoring and grading credit quality, measuring asset impairment, reporting impaired assets to APRA (and in published financial statements), valuing security and provisioning.
2. An ADI should regularly review its credit risk management system, taking account of the changing operating circumstances, activities and risks that it may face. An ADI must inform APRA immediately of any concerns that it has about the overall level of its credit risk where this has the potential to impair the capital adequacy of the institution.
3. A consistent approach to the measurement of credit risk (or asset quality) is at the heart of any good credit risk management system. Consistency is especially critical when questions arise as to the value of assets held, or to the ultimate collectibility of loans or other outstanding facilities to customers or related parties. Approaches to the measurement of credit

risk should be aligned closely to the particulars of each ADI. The more complex the business, the more reasonable it is to expect that sophisticated approaches to measurement of asset quality are being applied. Tailored approaches to measurement can also be applied where relatively simple asset portfolios are concerned, particularly where historical data on loss or default are readily available. In other cases, more specific approaches may be warranted.

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Scope

4. Impaired assets are defined as those items for which the ultimate collectibility of principal and interest is compromised. Impaired assets include all problem assets, off-balance sheet exposures and assets brought on to an ADI's balance sheet through enforcement of security provisions. Where a facility to a customer or group of related customers is impaired, all other exposures to that customer/group should be aggregated and classified as impaired, subject to exceptions in [AGN 220.1](#).
5. This Standard applies to exposures that are managed on an individual or transaction basis, and those that are managed on a statistical or portfolio basis. APRA will agree with each ADI the maximum value of individual facilities which may be reported on a portfolio basis.

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Classification of Impaired Assets

6. Impaired Assets should be recognised in three categories:
 - (a) *non-accrual items* - facilities against which a specific provision has been made, or a write-off taken (even if not in breach of the contractual requirements), and facilities which are "90 days past due" where the "net current market value" of the security as defined in [AGN 220.1](#) is insufficient to cover payment of principal and accrued interest. The item can be restored to accrual status if it subsequently becomes "well-secured" and there is no reasonable doubt about the ultimate collectibility of principal and interest;
 - (b) *restructured items* - facilities rendered non-commercial because of concessional contractual changes related to financial difficulties of the customer. Restructured items are to be reclassified as non-accrual if recovery of principal and interest is in doubt, or if

provisions have subsequently been struck. A restructured item which has operated on non-concessional commercial terms for at least 6 months may be restored to fully performing status; or

- (c) *other assets acquired through security enforcement*, including other real estate owned.

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Recognising Income on Non-Accrual Items

7. When an impaired asset is classified as non-accrual, an ADI should cease to recognise interest and other income earned but not yet received. Any accrued but unpaid interest and other income should generally be reversed back to the last reporting date or the date when interest and other income was last paid, whichever is more recent. Unpaid interest or other income dating back prior to the last reporting date should be reviewed to establish ultimate collectibility and a provision against loss raised as appropriate.

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Security Valuation

8. Each ADI should have appropriate policies, adopted by its Board or an appropriately delegated Board Committee, for establishing, recording and reviewing the value of securities held against exposures. All assets taken as security should be valued, where possible, at net current market value. Further details on security valuation are in [AGN 220.2](#).

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Provisioning

9. As part of its credit risk management system, an ADI should have provisioning policies covering the level of general and specific provisions that are needed to absorb estimated losses associated with the credit portfolio, and measure impaired assets, earnings and capital adequacy correctly. These should reflect the framework outlined in [AGN 220.2](#). The ADI's Board or its appropriately delegated Board Committee should adopt these policies.
10. Estimates of credit losses should account for all significant factors that affect the collectibility of the credit portfolio as at the evaluation date. The level of general and specific provisions should be reviewed regularly

to ensure that the amount of provisioning is consistent with current expectations of credit losses.

11. The Standard provides for two approaches to specific provisioning. APRA encourages ADIs to apply more sophisticated or internal model based approaches to provisioning, relying on the ADIs' own methodologies, supported by robust internal controls and subject to general accounting practices. Where APRA accepts that the sophisticated approach is not warranted, or judges an ADI's own provisioning practice to be inadequate in view of its credit risk profile, APRA will require the ADI to apply a standardised prescribed provisioning approach, described in [AGN 220.3](#), to determine its level of specific provisions.
12. Irrespective of the approach applied to determine specific provisions, APRA expects ADIs to formulate appropriate policies for the creation and maintenance of adequate general provisions (see [AGN 220.2](#)). An adequate general provision is required to account for those risks inherent in the business but which cannot be specifically identified.
13. In all cases, APRA needs to be satisfied that the proposed provisioning methodologies are sufficiently rigorous, appropriate to the risks involved, comparable to good practice techniques in place in ADIs with similar operations, and generating reasonable provisioning outcomes.

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Credit Risk Grading Systems

14. An ADI's credit risk management policy should include a well-structured credit risk grading system - adopted by the Board or a Board Committee and notified to APRA – that provides for a systematic assessment of asset quality. ADIs should risk grade all credit exposures. Exposures which are homogeneous and have similar risk characteristics, such as housing loans, credit cards, leases and hire purchase, may be grouped and be risk graded on a portfolio basis. If, after grouping, an ADI has a negligible number of individual exposures to risk grade, APRA may exempt the ADI from having to put in place a credit risk grading system.

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Reporting

15. An ADI must provide APRA each quarter (or more frequently if required by APRA) with information on asset quality in a form to be determined by APRA from time to time. (Refer [AGN 220.5](#))

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