



APRA

RESPONSE TO SUBMISSIONS

APS220 Credit Market Risk

DECEMBER 2019

Disclaimer and Copyright

While APRA endeavours to ensure the quality of this publication, it does not accept any responsibility for the accuracy, completeness or currency of the material included in this publication and will not be liable for any loss or damage arising out of any use of, or reliance on, this publication.

© Australian Prudential Regulation Authority (APRA)

This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0). This licence allows you to copy, distribute and adapt this work, provided you attribute the work and do not suggest that APRA endorses you or your work. To view a full copy of the terms of this licence, visit <https://creativecommons.org/licenses/by/3.0/au/>.

Contents

Executive summary	4
Glossary	6
Chapter 1 - Introduction	8
Chapter 2 - Role of Board and senior management	11
Chapter 3 - Credit origination, assessment and approval	12
3.1 Credit origination	12
3.2 Credit assessment and approval	12
Chapter 4 - Collateral valuations	14
4.1 Independent valuations	14
4.2 Fair values	14
4.3 External events	15
Chapter 5 - Asset classification and provisioning	17
5.1 Significantly deteriorated exposures	17
5.2 Non-performing exposures	17
5.3 Restructured exposures	18
Chapter 6 - Other issues	20
6.1 Implementation date	20
6.2 Consequential changes to other prudential standards	20
Chapter 7 - Consultation	21
7.1 Request for submissions	21
7.2 Important disclosure notice – publication of submissions	21
Attachment A: Regulatory costs	22

Executive summary

Credit risk is usually the single largest risk facing an authorised deposit-taking institution (ADI). The presence of a well-functioning credit risk management system is, therefore, fundamental to the safety and soundness of an ADI. As a result, APRA's Prudential Standard APS 220 Credit Quality requires an ADI to implement a credit risk management framework that is appropriate to its size, business mix and complexity.

In March 2019, APRA proposed to modernise the standard; this was prompted by APRA's recent supervisory focus on credit standards, and to reflect contemporary credit risk management practices. To better reflect the requirements of the standard, APRA also proposed to change the name of the standard to Prudential Standard APS 220 Credit Risk Management (APS 220).

The draft APS 220 proposed changes in the following areas:

- credit risk management, including credit standards and the ongoing monitoring and management of an ADI's credit portfolios over the full credit life-cycle; and
- asset classification and provisioning, taking into account updated Basel Committee on Banking Supervision (Basel Committee) guidance on credit-related matters and recent changes in accounting standards.

Importantly, the proposed changes also included the recommendation of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry relevant to APS 220 regarding the valuation of collateral taken by ADIs. As recommended by the Royal Commission, APRA proposed to amend APS 220 to require independent valuation of collateral, for the valuation to take into account the time taken for realisation of collateral and, to the extent possible, the likelihood of external events, such as drought and flood.

Submissions on APRA's consultation were broadly supportive of the proposed reforms. However, a number of submissions sought clarification of the role of the Board and senior management in credit risk management and the application of the proposed credit standards requirements for certain types of lending. Respondents also raised concerns regarding the proposed valuation of collateral and asset classification requirements.

APRA has made a number of adjustments to the proposals to address some of these issues, and has maintained other aspects of the original proposals where it has concluded these are warranted based on prudential considerations. Key adjustments to the proposals include:

- **credit standards** – the final APS 220 clarifies the scalable and flexible approach that should be applied to an ADI's credit assessment in the application of each of the credit standards requirements. In this regard, an ADI must use experienced credit judgement in adopting such an approach to its credit risk assessment of a borrower;
- **valuation of collateral** – in a manner consistent with the recommendation of the Royal Commission regarding the valuation of collateral taken by ADIs, APRA has clarified in the final APS 220 that valuation of collateral requirements do not require an ADI to predict

when 'external events' are likely to occur, and that 'external events' are wider than drought and flood. To align with international valuation and accounting standards, the final APS 220 no longer requires APRA approval for fair values to be based on highest and best use; and

- **asset classification** – to provide for a simpler classification for prudential reporting purposes, the term 'significantly deteriorated' has been removed from the final APS 220. ADIs will be required to classify exposures as 'performing' or 'non-performing' and as 'past-due' and 'restructured'. APRA has also amended its proposal for a twelve month period for a restructured exposure to return to performing status and is retaining the current six month requirement.

Further, some submissions suggested the implementation date for the final APS 220 should be deferred given APRA had proposed a 1 July 2020 start date. In light of the comments from submissions, and the time needed for ADIs to implement regulatory change, APRA has amended the implementation date of the final APS 220 to 1 January 2021. APRA expects that entities will review their existing credit risk management frameworks so their credit risk policies, processes and practices fully comply with the new standard from its effective date.

APS 220 fully implements the Royal Commission recommendation relevant to the standard. This response paper sets out the material issues raised in submissions and APRA's response to those issues.

This paper and the final prudential standard are available on APRA's website at www.apra.gov.au.

At this time, APRA is also releasing a draft Prudential Practice Guide APG 220 Credit Risk Management (APG 220) for consultation. Draft APG 220 provides guidance on APRA's view of sound practice in credit risk management, is intended to complement APS 220 and assist ADIs in meeting the requirements of the prudential standard.

APRA will separately consult on revised reporting requirements for credit risk management that would take effect at the same time as the final APS 220 and APG 220.

Glossary

ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
APG 220	Prudential Practice Guide APG 220 Credit Risk Management
APS 111	Prudential Standard APS 111 Capital Adequacy: Measurement of Capital
APS 112	Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk
APS 113	Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk
APS 220	Prudential Standard APS 220 Credit Risk Management
Basel Committee	Basel Committee on Banking Supervision
CPS 220	Prudential Standard CPS 220 Risk Management
Non-performing	An exposure that is in default. A default is considered to have occurred with regard to a particular borrower when either, or both, of the two following events have taken place: the ADI considers that the borrower is unlikely to pay its credit obligations to the ADI in full, without recourse by the ADI to actions such as realising available security; the borrower is 90 days or more past-due on a credit obligation to the ADI.
Past-due	An exposure for which any amount due under a contract (interest, principal, fee or other amount) has not been paid in full at the date when it was due. An exposure is considered past-due from the first day of missed payment.
90 days past-due	<p>An exposure subject to a regular repayment schedule is considered 90 days past-due when: at least 90 calendar days have elapsed since the due date of a contractual payment which has not been met in full; and the total amount unpaid outside contractual arrangements is equivalent to at least 90 days' worth of contractual payments. This includes all fees and any charges that are due but unpaid as a result of missed payments.</p> <p>Overdrafts are considered past-due once the borrower has breached an advised limit or been advised of a limit smaller than current outstandings. Non-authorized overdrafts are considered to have a zero limit for regulatory capital purposes. An ADI must, therefore, treat days past-due as commencing once any credit is granted to an unauthorised borrower and if such credit is not repaid within 90 days, the exposure must be considered to be in default.</p>

Restructured

An exposure for which a borrower is experiencing financial difficulty or hardship in meeting its financial commitments and the ADI grants a concession to the borrower that it would not otherwise consider, whether or not the concession is at the discretion of the ADI or the borrower.

Chapter 1 - Introduction

Credit risk is most simply described as the potential that a borrower will fail to meet its obligations in accordance with agreed terms. It is important for ADIs to manage the credit risk inherent in the entire portfolio as well as the risk in individual exposures or transactions.

In March 2019, APRA released a discussion paper proposing changes to APS 220, which requires ADIs to control credit risk by adopting prudent credit risk management policies and procedures¹.

APS 220 was last substantially updated in 2006, and there has been significant evolution in credit risk practices since then, including more sophisticated analytical techniques and information systems. APRA's plan to modernise the standard was prompted by its recent supervisory focus on credit standards, and to reflect contemporary credit risk management practices².

The discussion paper and draft APS 220 outlined APRA's proposals in the following areas:

- **credit risk management** – the draft APS 220 was broadened to include credit standards and the ongoing monitoring and management of an ADI's credit portfolios in more detail. It also incorporated enhanced Board oversight of credit risk and the need for ADIs to maintain prudent credit risk practices over the entire credit life-cycle; and
- **asset classification and provisioning** – the draft APS 220 provided a more consistent classification of credit exposures, by aligning recent accounting standard changes on loan provisioning requirements, as well as other guidance on credit related matters of the Basel Committee^{3, 4}.

The draft APS 220 also included the recommendation of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry relevant to the standard regarding the valuation of collateral taken by ADIs⁵.

¹ A copy of the discussion paper and draft APS 220 can be found on the APRA website.

² APRA Letter: Reinforcing sound residential mortgage lending practices, 9 December 2014; APRA Letter: Commercial property lending - thematic review considerations, 7 March 2017; APRA Letter: Further measures to reinforce sound residential mortgage lending practices, 31 March 2017; and APRA Letter: Embedding sound residential mortgage lending practices, 26 April 2018.

³ AASB 9 Financial Instruments (AASB 9) applies for reporting periods beginning on or after 1 January 2018 and replaced AASB 139 Financial Instruments: Recognition and Measurement (AASB 139).

⁴ The Basel Committee guidance on credit risk and accounting for expected credit losses, December 2015; and the Basel Committee guidance on the prudential treatment of problem assets - definitions of non-performing exposures and forbearance, April 2017.

⁵ Recommendation 1.12 - Valuations of land, The Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

To better describe the purpose of the standard, APRA also proposed renaming it Prudential Standard APS 220 Credit Risk Management.

The following Figure 1 describes the main components of the final standard:



Figure 1. Main components of APS 220

APRA received 15 submissions to its proposals, of which nine were confidential.

APRA has now finalised APS 220 following consideration of the submissions received. The following chapters set out the main issues raised in submissions. APRA has considered the issues raised and made amendments to the final standard.

At this time, APRA is also releasing a draft APG 220 for consultation. The draft APG 220 provides guidance on APRA's view of sound practice in credit risk management, is intended to complement APS 220 and assist ADIs in meeting the requirements of the prudential standard. The main elements of draft APG 220 include guidance on:

- the credit risk management framework;
- credit origination and assessment and approval;
- credit administration, measurement and monitoring;
- controls over credit risk;

- non-performing exposures;
- restructured exposures; and
- credit risk and accounting for expected credit losses.

The draft APG 220 draws on outcomes from APRA's recent supervisory focus on credit standards and Basel guidance on credit related matters.

Chapter 2 - Role of Board and senior management

In the draft APS 220, APRA proposed an enhanced Board oversight of credit risk with the Board required to review and approve, on at least an annual basis, the credit risk appetite and the credit risk management strategy of the ADI.

It was also proposed that an ADI's credit risk management strategy must consider the overall characteristics that the ADI would want to achieve in its credit portfolio.

APRA also specified in the draft APS 220 that senior management was responsible for implementing the credit risk management strategy approved by the Board.

Comments received

Some submissions questioned whether an annual review by the Board of the ADI's credit risk appetite and credit risk management strategy was necessary.

In approving an ADI's credit risk management strategy, it was also commented that the Board should not be required to approve 'target markets' and 'return levels' in the strategy – this is a task for senior management and may blur the distinction between oversight and management.

APRA response

APRA considers it appropriate that the Board review and approve, on at least an annual basis, the ADI's credit risk appetite and credit risk management strategy. This is because credit risk is typically the largest risk facing an ADI, and reviewing and approving the risk appetite and strategy complements the requirements in Prudential Standard CPS 220 Risk Management (CPS 220) for the Board to identify and consider material risks.

APRA has reconsidered its proposal for the Board to specifically consider 'return levels' and 'target markets' in approving its credit risk management strategy, and has amended the standard so that senior management must address such topics as target markets in developing and implementing credit risk policies consistent with the ADI's credit risk appetite.

Chapter 3 - Credit origination, assessment and approval

3.1 Credit origination

In the draft APS 220, APRA proposed that an ADI must recognise and address the risks arising from different origination channels in its credit risk management framework.

Comments received

Submissions were concerned that proposed requirements to verify the accuracy and completeness of 'any' borrower information provided by a third party imposed additional obligations on ADIs which are inconsistent with an ADI's general responsible lending obligations.

APRA response

Whilst an ADI may employ various origination channels to widen product distribution, such channels used without discipline can introduce heightened risk into the credit portfolio of an ADI. Where such third-party channels are used, it is appropriate for ADIs to review the quality of these exposures, including ensuring reasonable steps have been taken to verify the accuracy and completeness of 'any' borrower information provided (e.g. undertaking regular audits or other compliance checking).

The requirement in APS 220 relates to the oversight by the ADI of third parties (e.g. brokers and introducers) and is not intended to impose any additional requirements with respect to an ADI's general responsible lending obligations.

3.2 Credit assessment and approval

In the draft APS 220, APRA proposed specific requirements for credit standards. These requirements were drawn from APRA's previous pronouncements on credit risk, particularly its recent supervisory measures to reinforce sound residential mortgage lending practices.

The draft APS 220 distinguishes credit assessment of 'exposures to individuals' and 'exposures to other than individuals'.

Comments received

Some submissions commented that the proposed requirements for 'exposures to individuals' should not apply to small and medium enterprise (SME) lending.

It was also suggested that the draft APS 220 should refer to an ADI undertaking 'reasonable steps' to verify borrower information.

Clarification was also sought as to whether the proposed requirements for 'exposures other than to individuals' should be read in conjunction with preceding paragraphs in the draft APS

220 that provide for credit assessment to be proportionate to the nature, type and size of the exposure.

It was also commented that the draft APS 220 may restrict innovation and competition by imposing inflexible obligations on ADIs which are not 'scalable', particularly for credit cards and other smaller loan types.

Another submission noted that not all credit assessments for 'exposures other than to individuals' would include an assessment of historical financials and future cash flows.

APRA response

APRA expects an ADI's assessment of a borrower's credit risk would consider and be proportionate to the nature, type and size of the exposure. An ADI would be expected to exercise experienced credit judgement in considering the credit risk relevant to each exposure as not all aspects of the requirements would be relevant to certain credit products and activities. The final APS 220 has been amended to clarify this scalable and flexible approach to credit assessment.

APRA has also reworded the final APS 220 so that an ADI would make 'reasonable inquiries' and take 'reasonable steps' to verify a borrower's financial situation.

APRA has also provided guidance in the draft APG 220 of its expectations of an ADI's credit assessment. For example, APRA would not expect the same comprehensive credit assessment be undertaken for a commercial loan and a small unsecured personal loan.

In regard to an ADI's assessment of a borrower's historical financials and future cash flows, the draft APG 220 notes that start-up businesses would typically provide cash flow projections only; for existing businesses an ADI may also rely on historical performance of the business for credit assessment purposes.

Chapter 4 - Collateral valuations

4.1 Independent valuations

In the draft APS 220, APRA proposed that an ADI must ensure all valuations are appraised independently from the ADI's credit origination, credit assessment and approval process. Conflict of interest is evident if persons who undertake the valuation are the same as those who are involved in the origination, assessment and approval of the exposure.

Comments received

Some submissions sought confirmation that this proposal meant that a property must be valued (appraised) by someone independent and did not mean that the valuation itself must be determined independently and then appraised by an independent person as a second review.

Other submissions noted the valuation of security occurs in a manner more appropriate to the collateral type. For example, SME loans would typically be collateralised by a general security agreement over the business or a motor vehicle valuation can be achieved independently through motor vehicle valuation guides.

APRA response

Persons involved in the credit origination, assessment and approval process may have an inappropriate incentive to arrive at an optimistic view of the quality of collateral. This may result in some borrowers being over-extended at origination.

APRA has clarified in the draft APG 220 the requirement that persons who undertake a valuation must not be the same as those persons who are involved in credit origination, assessment and approval. This does not mean that only external valuations must be undertaken. Internal valuations may be undertaken by suitably qualified persons who are removed from the credit origination, assessment and approval process.

4.2 Fair values

Under the current APS 220, property assets must, unless otherwise agreed with APRA, be valued on the basis of existing use.

In the draft APS 220, APRA reiterated that the valuation of collateral must reflect fair values, taking into account prevailing market conditions such as time taken for the liquidation or realisation of collateral.

Comments received

Some submissions were concerned that restricting valuations to existing use is inconsistent with international valuation standards and accounting standards. It was also commented that requiring valuations to be undertaken on only the existing use of a property may reduce valuations for business and the consequent flow of credit. To align with international

valuation standards and accounting standards, it was requested that highest or best use be permitted without the need for APRA approval. Other submissions commented that it was unclear whether Attachment A of draft APS 220 regarding collateral and security valuation intended to cover all forms of security.

APRA response

APRA has reworded the final standard to avoid inconsistency with international valuation standards and accounting standards and has removed the requirement for APRA approval of valuations that are not based on existing use.

In determining fair values, APRA has included in the final APS 220 a requirement that any valuation based on highest and best use rather than existing use must be adequately supported and documented. Where applicable, the valuation report must set out how highest and best use was determined.

Collateral can include guarantees, insurance arrangements and, importantly, security held over various forms of assets. Whilst most of the requirements in Attachment A to APS 220 are relevant to the valuation of security in the form of property, some of the requirements may not be relevant to other forms of security. APRA has clarified in the final standard that an ADI must apply Attachment A to APS 220, having regard to the nature and type of security held.

4.3 External events

In line with the recommendation of the Royal Commission in its final report (Recommendation 1.12), the draft APS 220 included a proposal that an ADI must ensure the valuation of agricultural land takes into account the likelihood of external events, such as drought and flood, which may impact the valuation of the land.

Comments received

Submissions commented that reference in the draft APS 220 to external events may infer that valuations need to go further than current practice, such as predicting likely external events, which is not possible.

Submissions also noted that valuations already take into consideration known environmental issues. If the property is in a known drought and/or flood location, then this would be noted in the valuation report as a statement of fact, and the related risks would form part of the valuation. However, the valuation is not able to predict when an 'external event' will occur.

APRA response

Consideration of external events is essential in determining fair values and the setting of conservative loan-to-valuation ratios. This is to ensure, for example, that ADIs do not inflate the value of collateral to facilitate the approval of loans.

APRA has clarified in APS 220 that the valuation of collateral such as land must take into account, to the extent possible, external events and these are not limited to drought and flood.

This does not mean valuations must predict when an 'external event' will occur, only that the related risks of such events would form part of the valuation. Fair values would be based on a measurement date under current market conditions.

Chapter 5 - Asset classification and provisioning

5.1 Significantly deteriorated exposures

In the draft APS 220, APRA defined 'significantly deteriorated' as an exposure for which provisions are measured on a life-time expected credit loss basis under accounting standards but which is not non-performing. Such classification was intended to complement Stage 2 of the credit risk stage model under Australian Accounting Standard AASB 9 Financial Instruments.

Comments received

A number of submissions commented that 'significantly deteriorated' has a more adverse connotation from an asset quality standpoint that may mislead users and that APRA should consider establishing minimum threshold or criteria for what constitutes 'significantly deteriorated'.

Other submissions requested APRA provide a more comprehensive definition of 'significantly deteriorated'. Classification of credit risk exposures as 'significantly deteriorated' is too ambiguous, and should be relabelled to aid clarity.

Submissions also commented that fair value loans should be excluded from the proposed asset classification as fair value loans are covered by Australian Accounting Standard AASB 13 Fair Value Measurement (as opposed to AASB 9).

APRA response

To avoid confusion and simplify the standard, APRA has removed the term 'significantly deteriorated' from APS 220. ADIs will be required to classify assets as 'performing' or 'non-performing' and 'past-due' and 'restructured'. (See 5.2 Non-performing below.)

5.2 Non-performing exposures

In the draft APS 220, APRA defined 'non-performing' as an exposure that is in default as defined in Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (APS 113). This definition was broadly consistent with the Basel guidance which included the regulatory definition of default.

Comments received

In relation to 'non-performing', submissions commented that contractual payment and materiality threshold provisions should be restored in APS 220. 'Non-performing' exposures should also be defined under APS 220 rather than APS 113.

It was also commented that ADIs with 'non-performing' loans that are otherwise well-secured will see a spike in their reported figures to APRA.

APRA response

APRA notes that the current APS 220 refers to contractual payment and materiality threshold provisions and these were inadvertently not included in the draft APS 220. This includes the definition of 90 days past-due for exposures subject to a regular repayment schedule and exposures that do not have a contractual repayment schedule (e.g. overdrafts and revolving credit facilities). APRA has restored the relevant provisions in APS 220.

To avoid confusion for those ADIs subject to APS 112, APRA has included the regulatory definition of default in APS 220 and removed the cross reference to APS 113.

For prudential reporting purposes, APRA notes the definition of non-performing exposures is likely to result in a higher level of reported problem exposures relative to APRA's current definition of impaired exposures, but will not necessarily lead to an increase in provisions.

5.3 Restructured exposures

In the draft APS 220, APRA proposed that an ADI must classify a restructured exposure as non-performing until it meets both of the following exit criteria: when all payments, as per the revised contractual terms, have been made in a timely manner over a continuous repayment period of not less than twelve months; and the borrower has resolved its financial difficulty.

Comments received

Most submissions requested that APRA retain the six-month continuous repayment period (probation period) rather than introducing a twelve month probation period. Some respondents advised that their data shows that only a very small number of hardship customers fall back into arrears between six and twelve months. It was also commented that there would be additional costs associated with managing system changes and monitoring customer accounts with a twelve month period.

Other submissions requested alignment of the standard with the definitions used for reporting restructured exposures used in the Basel guidance. Clarity was also sought on whether all restructured exposures were to be reported as non-performing.

Some submissions commented that the list of concessions in the draft APS 220 mixed significant restructuring initiatives with relatively immaterial changes that may be commercially available to borrowers in good standing.

It was also commented that the draft APS 220 did not provide a specific exception from the restructured classification those agribusiness borrowers experiencing financial difficulties, but have demonstrated long term viability.

APRA response

On the understanding that a small number of hardship customers have fallen back into arrears after six months, and the likely increased burden and costs on ADIs of the proposal, APRA has changed its proposal for a twelve month period for a restructured exposure to return to performing status and is retaining the current six month requirement.

In line with the relevant Basel guidance, APRA has also clarified in the standard that a restructured exposure may be granted on performing or non-performing exposures. In addition, APRA has provided more detail in APS 220 around the interaction of restructured with non-performing exposures.

APS 220 lists a number of examples of concessions. APRA has provided guidance in the draft APG 220 that these relate to concessions to the borrower which are on non-commercial terms. Restructured exposures would include exposures where the underlying loan terms are contractually reduced or otherwise modified in a manner that would not be commercially available to other borrowers in good standing.

APRA has also restored in APS 220 its longstanding requirement that an exposure that is not subject to the National Credit Code need not be reported as restructured where it is placed on restructured terms for less than twelve months due to financial difficulty being experienced by the borrower but where long-term viability is unquestioned (e.g. an agricultural exposure encountering a bad season).

Chapter 6 - Other issues

6.1 Implementation date

APRA proposed to implement the proposed reforms from 1 July 2020.

Comments received

Some submissions suggested the implementation date should be set to at least one year from the publication of the finalised APS 220 and APG 220, and the associated reporting standard, reporting forms and reporting form instructions.

APRA response

In light of the comments from submissions, and the need for APRA to have regard to the time available for industry to implement regulatory change, APRA has changed the implementation date of the final APS 220 to 1 January 2021.

6.2 Consequential changes to other prudential standards

APRA notes that some consequential changes are required to other prudential standards to support implementation of the final APS 220. These changes, for the most part, involve cross referencing and include changes to Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111), APS 112 and APS 113. APRA proposes to make these consequential changes when these other standards are next updated and after the final APS 220 becomes effective.

Chapter 7 - Consultation

7.1 Request for submissions

APS 220 is now final and submissions are closed. However, APRA invites written submissions on the draft APG 220. Written submissions on the draft APG 220 should be sent to ADIpolicy@apra.gov.au by 12 March 2020 and addressed to:

General Manager

Policy Development

Policy and Advice Division

Australian Prudential Regulation Authority

7.2 Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence.

Automatically generated confidentiality statements in emails do not suffice for this purpose.

Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

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. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the Australian Prudential Regulation Authority Act 1998 and will therefore be exempt from production under the FOIA.

Attachment A: Regulatory costs

This attachment formalises and documents the steps taken in finalising APS 220.

In its March 2019 Discussion Paper, APRA outlined the problem in regard to APS 220, the prudential regulation of credit risk management and why regulatory initiatives were needed. (Refer to the March 2019 Discussion Paper, Chapter 1 Introduction on pages 8 and 9)

The three policy options to address the problem in regard to APS 220 and preliminary analyses of each option were also outlined in APRA's March 2019 Discussion Paper. (Refer to March 2019 Discussion Paper, Attachment A: Policy options and estimated comparative net benefits on pages 28 and 29).

These three policy options were as follows:

Option 1	No change to the existing APS 220.
Option 2	A narrow update of APS 220 to reflect Basel guidance and AASB 9.
Option 3	A broader update of APS 220 to reflect best practice credit risk management expectations, including the relevant recommendation of the Royal Commission, Basel

The material difference between the second and third options is the update to the prudential standard to reflect best practice credit risk management expectations, including the relevant recommendation of the Royal Commission.

Assessment of regulatory costs

APRA specifically invited submissions on any increases or decreases to regulatory costs incurred as a result of each option. Respondents were invited to use the Australian Government's Burden Measurement Tool to assess regulatory costs⁶. None of the submissions took up the invitation to use this tool.

APRA has considered all relevant compliance costs (e.g. administration and substantive compliance costs and delay costs) in estimating the regulatory cost of each option.

For the second and third options, APRA has estimated total industry costs based on the number of ADIs, the cost per hour and the number of hours and personnel likely to be required to implement the proposals. APRA does not expect costs to be incurred specifically

⁶ This tool calculates the compliance costs of regulatory proposals on business, individuals and community organisations using an activity-based costing methodology. The tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: <https://rbm.obpr.gov.au/home.aspx>.

for implementation following the first year but has represented the costs in the tables below as annual regulatory costs averaged over 10 years.

Option 1

Under the first option, ADIs and other stakeholders would not incur any additional compliance costs.

Annual regulatory costs, averaged over 10 years (\$m)

Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	0	0	0	0

Under the status quo, peer group comparisons with banks in other jurisdictions would remain difficult since regulators in these jurisdictions are likely to take account of Basel guidance as the basis for their regulatory reporting.

The existing standard would continue to reflect concepts and terminology commensurate with an outdated accounting standard. This is likely to create some confusion for ADIs and APRA, particularly in relation to provisioning.

It is likely that ADIs' credit risk management may be adversely affected if best practice credit risk management expectations, including the relevant recommendation of the Royal Commission, are not reflected in the standard. Although APRA's previous pronouncements on credit risk remain relevant, they do not create enforceable requirements.

Option 2

Under Option 2, ADIs would incur additional compliance costs. APRA estimates the total cost to be \$17.3 million.

Annual regulatory costs, averaged over 10 years (\$m)

Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	1.73	0	0	1.73

Under this option, peer group comparisons with banks in other jurisdictions would be enhanced since regulators in these jurisdictions are likely to take account of Basel guidance as the basis for their regulatory reporting.

Aligning the prudential standard with the new accounting standard would provide greater clarity and transparency for ADIs and APRA.

ADIs would incur additional compliance costs associated with an update to an ADI's credit risk policies, processes and systems to reflect the Basel guidance. ADIs would need to understand the updated APS 220 and train staff in these particular areas.

Compliance costs also include costs associated with an update to ADIs' regulatory reporting requirements. The additional cost under the second option involve an update to reporting forms which will require some system changes. APRA considers that each ADI would have the existing data to complete updated reporting forms and that any system changes would be accommodated under existing infrastructure.

In terms of compliance costs, the update to APS 220 to reflect accounting standard changes is not expected to have any significant impact on ADIs as ADIs are already required to comply with AASB 9 for reporting periods beginning on or after 1 January 2018 and APS 220 is being updated to align with the accounting standard.

APRA considers there are no delay costs in relation to the second option (e.g. expenses and loss of income incurred by an ADI through an application delay or an approval delay) as there is no requirement for an application or approval under APS 220.

Under the second option, APRA envisages a start date of 1 January 2021 for the introduction of the reforms. APRA considers there would be sufficient notice of proposed prudential standard and reporting requirements to allow ADIs to undertake any necessary changes to credit risk policies, processes and systems and reporting processes. When estimating compliance costs for business, given the quantum of compliance costs, APRA considers it likely these compliance costs would be absorbed by business.

Option 2 is not expected to have a material impact on competition as APRA's expectations for the credit risk management approach used by individual ADIs is commensurate with the scope and sophistication of the ADI's activities. Changes to APS 220 for asset classification changes and to reflect the new accounting standard are not expected to have a material impact on competition as APRA is aligning the prudential requirements with the Basel guidance and the new accounting standard.

However, it is likely that ADIs' credit risk management may be adversely affected if best practice credit risk management expectations, including the relevant recommendation of the Royal Commission, are not reflected in the standard. Although APRA's previous pronouncements on credit risk remain relevant, they do not create enforceable requirements.

Option 3

Under Option 3, ADIs would also incur additional compliance costs, and these are likely to be larger than Option 2. APRA estimates the total cost to be \$32.8 million.

Annual regulatory costs, averaged over 10 years (\$m)

Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	3.28	0	0	3.28

The compliance costs under Option 3 are similar to that of Option 2, however under Option 3, ADIs would also incur additional compliance costs associated with an update to an ADI's credit risk policies, processes and systems to reflect best practice credit risk management expectations, including the recommendation of the Royal Commission. ADIs would also need to understand the updated APS 220 and train staff in these particular areas.

The Royal Commission's recommendation for valuations to be undertaken by suitably qualified persons who are removed from the credit origination, assessment and approval process and for valuations to take into account the likelihood of external events, such as drought and flood, may have some cost impacts. However, ADIs are already expected to follow best practice credit risk expectations and therefore embedding these as requirements in the prudential standard may not add significantly to costs.

Option 3 is not expected to have a material impact on competition as APRA's expectations for the credit risk management approach used by individual ADIs is commensurate with the scope and sophistication of the ADI's activities. Changes to APS 220 for asset classification changes, to reflect the new accounting standard, and best practice credit risk management expectations are not expected to have a material impact on competition as APRA is aligning the prudential requirements with the Basel guidance, the new accounting standard and ADIs are already expected to follow APRA's previous pronouncements on credit risk.

Conclusion

Option 1 results in no change in compliance costs, as it involves maintaining the current prudential framework without change. Options 2 and 3 result in compliance costs for industry.

Option 2 results in moderate to high net cost overall.

Option 3 results in moderate to high net cost overall.

APRA considers Option 3 to be the best option, as this option provides for best practice credit risk management expectations, including the Royal Commission recommendation, to be reflected in APS 220 and be legally enforceable.

APRA's mandate includes balancing the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, and, in balancing these objectives, promote financial system stability in Australia. APRA considers that, on balance, Option 3 will enhance prudential outcomes, improve financial safety and promote financial system stability in Australia.

	Option 1	Option 2	Option 3
Regulatory costs	No change	Moderate to high cost	Moderate to high cost
Basel guidance and accounting standard changes	Does not meet this criteria	Meets this criteria	Meets this criteria
Best practice credit risk management expectations, including Royal Commission recommendation	Does not meet this criteria	Does not meet this criteria	Meets this criteria
Overall	High net cost	Moderate to high net cost	Moderate to high net cost



APRA