RESPONSE TO SUBMISSIONS

A more flexible and resilient capital framework for ADIs

8 December 2020

Disclaimer Text

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Glossary

ADI	Authorised deposit-taking institution
AIRB	Advanced IRB approach
APRA	Australian Prudential Regulation Authority
APG 112	Prudential Practice Guide APG 112 Capital Adequacy: Standardised Approach to Credit Risk
APS 110	*Prudential Standard APS 110 Capital Adequacy*
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 III framework	A series of reforms to the internationally agreed capital framework following the global financial crisis that commenced with the Basel Committee on Banking Supervision's *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010, revised June 2011) and includes the following reforms: • *Basel III: Finalising post-crisis reforms* (December 2017) which includes revisions to the frameworks for credit risk, credit valuation risk and operational risk, and introduces a floor on risk-weighted assets using the standardised approaches and a non-risk-based minimum leverage requirement; • *Minimum capital requirements for market risk* (January 2019); and • *Interest rate risk in the banking book* (April 2016).
Basel Committee	Basel Committee on Banking Supervision
CCB	Capital conservation buffer
CCyB	Countercyclical capital buffer
CCF	Credit conversion factor
EAD	Exposure at default
FIRB	Foundation IRB approach
IPRE	Income-producing real estate
IRB ADI	An ADI that has been granted approval from APRA to adopt the internal ratings-based approach for determining its capital adequacy requirements for credit risk
LATP	Loss absorption trigger point
LGD	Loss given default

LMI	Lenders' mortgage insurance
LVR	Loan-to-valuation ratio
PD	Probability of default
QIS	Quantitative impact study
QRR	Qualifying revolving retail
RBNZ	Reserve Bank of New Zealand
RWA	Risk-weighted assets
SA-CCR	Standardised approach to counterparty credit risk
SFT	Securities financing transaction
SME	Small- and medium-sized enterprise
Standardised ADI	An ADI that uses the standardised approach to credit risk to determine its capital adequacy requirements

Chapter 1 - Introduction

1.1 Background

APRA's consultation on revisions to the capital framework for authorised deposit-taking institutions (ADIs) commenced in February 2018. This is a large and complex initiative that has included a number of consultations on proposals and draft prudential standards, as APRA continues to enhance the capital framework.

This paper accompanies the *Discussion paper: A more flexible and resilient capital framework for ADIs* (discussion paper) and provides a more detailed response to technical issues that were raised in submissions. Specifically, this paper responds to submissions received on proposals relating to revisions to *Prudential Standard APS 110 Capital Adequacy* (APS 110), *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) and *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113). A breakdown of the number of submissions received in response to each previous consultation is included below, with non-confidential submissions published on APRA's website.

Table 1. Prior consultations

Discussion paper	Number of submissions
Revisions to the capital framework for ADIs (February 2018) – IRB proposals	18
Improving the transparency, comparability and flexibility of the ADI capital framework (August 2018)	8
Revisions to the capital framework for ADIs (June 2019) – standardised approach & IRB mortgage proposals	17
Leverage ratio requirement for ADIs (November 2019)	2

1.2 Next steps

APRA invites written submissions on the proposals set out in this response paper. In particular, APRA seeks views on:

1. the proposals on the capital framework, regulatory capital buffers and the capital floor for ADIs that use the internal ratings-based approach to credit risk (IRB ADIs);

2. the revised eligibility criteria for, and components of, the simplified framework for smaller ADIs;

3. feedback on the draft APS 110, APS 112, and APS 113;

4. whether the proposed implementation date of 1 January 2023 should be brought forward for the full implementation of the reforms; and
5. estimates of the cost impact arising from the regulatory change set out in these proposals.

Written submissions should be submitted to APRA by 1 April 2021 (see Chapter 7).

1.2.1 Quantitative Impact Study

As part of this consultation, APRA will also be undertaking a quantitative impact study (QIS) and will be asking a number of ADIs to participate. APRA will use the data collected to refine proposals set out in the draft prudential standards, and also to ensure that the capital framework is appropriately calibrated to meet the 'unquestionably strong' capital benchmarks.

APRA will shortly contact a sample of ADIs, including a range of different-sized entities, to request participation in the QIS on a 'best endeavours' basis. ADIs may also elect to contribute data to the exercise by contacting their responsible supervisors. Individual data submitted by ADIs will remain confidential.

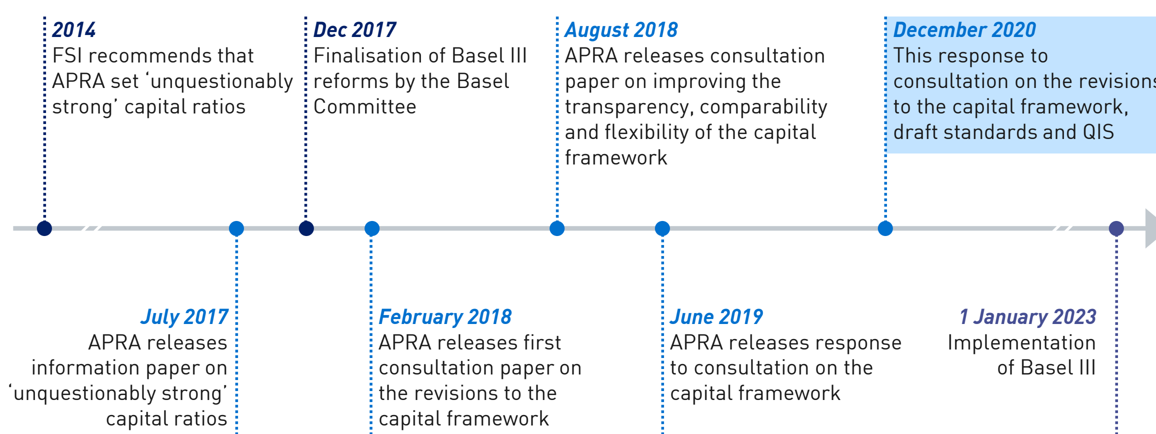
1.2.2 Consequential amendments

APRA intends to consult on a revised *Prudential Standard APS 330 Public Disclosure*, revised reporting standards and revised prudential practice guides in 2021. APRA will also consult on consequential amendments to a number of prudential standards, including *Prudential Standard APS 210 Liquidity* and the net stable funding ratio calculation, as the capital reforms are finalised.

1.2.3 Implementation

APRA intends to implement the revised capital framework on 1 January 2023, consistent with the international timetable; however, APRA is open to an earlier implementation of the full set of reforms. To ensure consistent prudential outcomes across the banking sector, APRA considers that it is most appropriate to implement the full suite of reforms, rather than accelerate certain components.

Figure 1. Timeline



1.3 Outline of this response paper

APRA's response to submissions as set out in this paper, largely follows the contents of the relevant prudential standards.

Chapter 2 outlines proposed changes to APS 110 and details APRA's response to the consultation on improving the transparency, comparability and flexibility of the capital framework, implementation of the capital floor and the leverage ratio.

Chapter 3 sets out further details on APRA's proposed approach to the simplified framework for small, less complex ADIs.

Chapter 4 details APRA's response to residential mortgages under both the standardised and IRB approaches.

Chapter 5 sets out APRA's response to other components of the standardised approach to credit risk.

Chapter 6 details proposed changes to APS 113 and includes APRA's response to the February 2018 IRB proposals.

Chapter 7 includes additional details on how to provide a submission in response to this consultation package.

Chapter 2 - APS 110

This chapter outlines proposed changes to APS 110, as well as APRA's response to the consultations on improving the transparency, comparability and flexibility of the capital framework, implementation of the capital floor and the leverage ratio. The draft revised APS 110 accompanying this response paper has been marked-up relative to the November 2019 consultation version.

2.1 Improving transparency, comparability and flexibility

In August 2018, APRA consulted on proposals to improve the transparency, comparability and flexibility of the capital framework. APRA noted that if the differences in how it has tailored the international Basel minimum framework to Australian conditions were not well understood, the capital strength of ADIs may be underestimated. APRA sought views on two conceptual approaches to improving the transparency and comparability of the capital framework:

- Approach one - consistent disclosures: developing more consistent disclosures without modifying the underlying capital framework; and
- Approach two - capital ratio adjustments: modifying the capital framework by adjusting the methodology for calculating capital ratios to utilise more internationally harmonised definitions of capital and risk-weighted assets (RWA), and to apply corresponding increases in ratio requirements.

APRA also highlighted that retaining the status quo, or a combination of approaches one and two, were also viable options.

Regardless of any approach(es) adopted, APRA intended to make the capital framework more flexible in times of stress. A more flexible capital framework is one that can respond appropriately to the prevailing environment. In a time of stress, for example, this means that the capital framework can act countercyclically and better support the ability of the financial system to absorb losses and continue lending to credit-worthy borrowers.

To increase flexibility, APRA signalled its intention to introduce a non-zero default level of the countercyclical capital buffer (CCyB) and to increase the size of regulatory capital buffers relative to minimum prudential capital requirements (PCRs). APRA also highlighted potential consequential changes to the point of automatic regulatory interventions, such as the level of the loss absorption trigger point (LATP) included in Additional Tier 1 capital instruments.

Comments received

There were a number of different views from respondents on the two approaches and on the implementation of the approaches. Certain respondents highlighted that, for some ADIs, the benefits of greater comparability would be outweighed by the costs of additional disclosures or adjustments, and supported either voluntary approaches or no change. For these stakeholders, minimising the burden of change was a priority. Otherwise, the majority of respondents supported the second approach. Respondents requested that APRA capture all

adjustments to the minimum Basel framework in the calculation of RWA and in the definition of capital that are material in size, and are able to be calculated simply and objectively. Respondents suggested that APRA's approach to capital deductions and risk estimates used in IRB expected loss calculations should be captured in additional adjustments to further improve the international comparability of ADI capital ratios. Supporters of the second approach also suggested modifications to the overall framework to reduce operational complexities; for example, applying asset class scalars to internationally consistent RWA rather than having to calculate RWA under multiple methodologies.

Respondents were supportive of capital adjustments being allocated to regulatory buffer requirements rather than allocating increases to the PCR, or proportionally between the PCR and capital conservation buffer (CCB). Other suggestions included adding a new buffer that sits above the CCB that would not be subject to automatic distributions constraints. There were wide-ranging views about whether this buffer should be set at an industry level, or based on total RWA for specific types of exposures. The majority of respondents recommended maintaining the LATP at 5.125 per cent of total RWA, consistent with international practice.

APRA's response

To improve the transparency and international comparability of ADI capital ratios, APRA is proposing greater alignment with the Basel framework compared to APRA's current framework. APRA is proposing to make adjustments to the Basel framework only where they address risks specific to the Australian context, or where an alternative approach supports simplicity and lessens regulatory burden. These adjustments will be implemented in a transparent manner, such as through the application of multipliers to RWA outcomes.

The closer alignment with the Basel framework will also improve international comparability by allowing internationally active Australian ADIs to more easily demonstrate their relative capital strength. APRA also considers that comparability between domestic ADIs will be improved by the requirement that IRB ADIs calculate and disclose RWA under the standardised approach.

Changes to buffer requirements

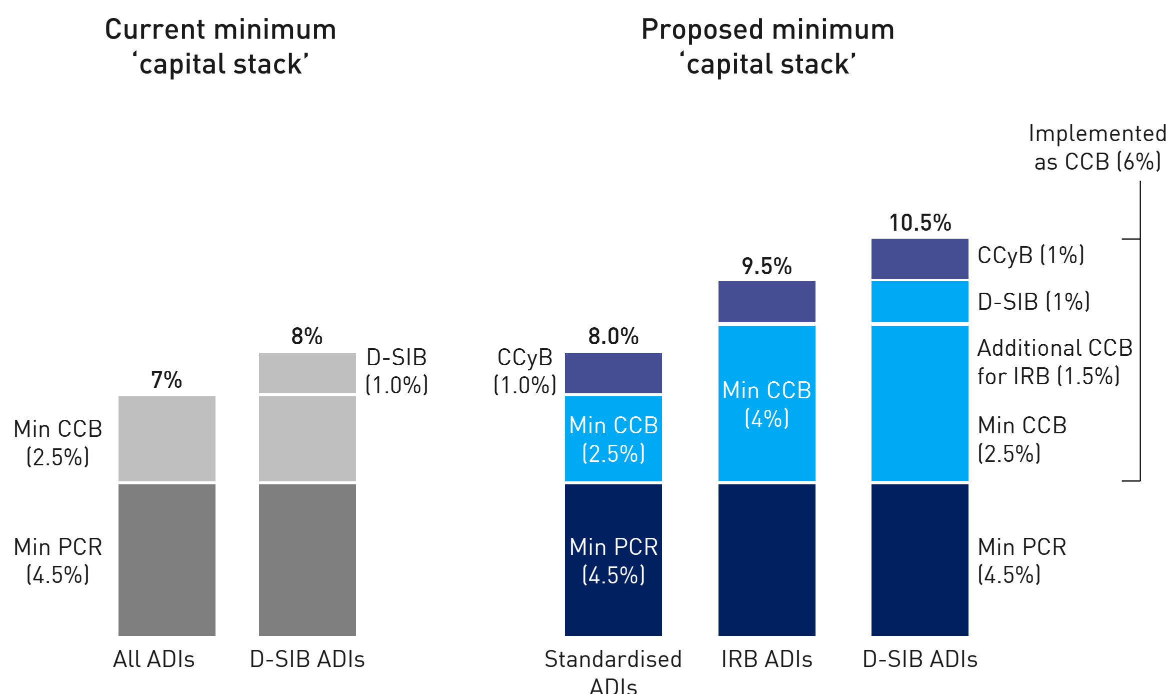
To improve the flexibility of the capital framework, APRA intends to increase the size of regulatory capital buffers. APRA's preference is to keep the framework simple by expanding existing buffers, rather than introducing new buffers. A number of amendments have been made to APS 110 to give effect to the revised buffer regime.

- Capital Conservation Buffer: to give effect to a larger buffer for IRB ADIs, APRA is increasing the level of the CCB by 150 basis points. The new regulatory minimum and buffer requirement for IRB ADIs, reflecting the sum of CET 1 PCR plus the CCB, is therefore no less than 8.5 per cent of total RWA. For IRB ADIs that have been designated as a domestic systemically important bank (D-SIB), the new regulatory minimum and buffer requirement is 9.5 per cent. There are no changes to the minimum CCB for standardised ADIs.

- Countercyclical Capital Buffer: to give effect to a non-zero default level CCyB, APS 110 has been amended to reflect that APRA will determine the level of the Australian jurisdictional CCyB within the range of zero to 3.5 per cent of RWA. APRA anticipates that

under normal economic conditions, the default level of the CCyB will be 1.0 per cent of RWA. Setting the default buffer at this level allows APRA to materially release capital requirements in times of stress, as well as further increase capital requirements in response to increasing systemic risk.

Figure 2. Changes to the CET1 'capital stack'



The CCyB is currently set at 0% of RWA. APRA is calibrating the proposed framework to a non-zero default CCyB of 1% of RWA – actual CCyB at the time of implementation may be different.
All regulatory buffers are operationalised as an extension of the CCB.
The 4 major banks (ANZ, CBA, NAB, WBC) are designated D-SIBs and are also IRB ADIs.

Prudential Capital Requirements and the loss absorption trigger point

APRA is proposing to retain the PCR at 4.5 per cent of RWA and the LATP at 5.125 per cent of total RWA. Retaining the calibration at these levels, rather than increasing either the PCR or LATP to offset the decline in the dollar value of capital, supports a greater proportion of capital being held in the form of a buffer. As detailed above, APRA expects that expanding the buffer framework will improve the flexibility of the capital framework in times of heightened risk or stress.

2.2 Capital floor

Consistent with the Basel III framework, APRA proposed introducing an RWA floor that would limit the capital benefit of modelled estimates under the IRB approach relative to the standardised approach. The capital floor will require that IRB ADIs apply the higher of total RWA calculated under the IRB approach and 72.5 per cent of total RWA calculated under the standardised approach.

Comments received

Respondents expressed mixed views on the proposed introduction and application of the capital floor. Some respondents suggested that APRA need not implement the capital floor as other adjustments to the IRB approach would ensure that total IRB RWAs were greater than 72.5 per cent of standardised RWAs.

Other respondents supported the introduction of the RWA floor as a means of improving competition between standardised and IRB ADIs. These respondents suggested that the capital floor should be greater than 72.5 per cent, or applied at an asset class or loan level, so that it limits the capital benefits of the IRB approach on an individual exposure basis.

Respondents also noted that APRA would need to provide further clarity on the assumptions underlying the capital floor calculation, such as at what level of consolidation the floor will be applied and whether interest rate risk in the banking book (IRRBB) would be excluded.

APRA's response

The capital floor is a core component of the revised Basel III framework. Consistent with the Basel framework, APRA proposes to proceed with applying a capital floor of 72.5 per cent at the aggregate RWA level. The capital floor is intended to operate as a backstop measure that limits the extent to which the application of the IRB approach can lead to lower overall capital requirements relative to the standardised approach; it is not designed or intended to be the binding constraint for allocating capital at the level of a specific portfolio or exposure. APRA is proposing to introduce other adjustments to capital requirements for residential mortgages, which are a key area of competition amongst standardised and IRB ADIs (see Chapter 4). Further, it is important to highlight that the capital floor does not capture all differences between standardised and IRB capital requirements; it only captures differences in RWA. The gap between standardised and IRB capital requirements is further reduced by the additional 150 basis point CCB requirement for IRB ADIs.

APS 110 has been amended to reflect the introduction of the capital floor, which is intended to apply at both Level 1 and Level 2 (where applicable). The calculation of the floor will be based on APRA's standardised approach calculation. The requirement to calculate and disclose RWA under the standardised approach will also facilitate domestic comparisons between the capital ratios of standardised and IRB ADIs.

APRA is proposing to include IRRBB and the proposed RWA multipliers in the capital floor calculation. This is consistent with APRA's inclusion of IRRBB and IRB adjustments as part of the minimum framework (Pillar 1), rather than institution-specific supervisory adjustments (Pillar 2). APRA considers that this approach will also improve comparability between the standardised and IRB approaches under the Australian framework.

Figure 3. Components of the capital floor

RWA calculated under the IRB approaches	Credit risk	Operational risk	Market risk	IRRBB
	Counterparty credit risk	CVA	Securitisation	

≥ 72.5%

RWA calculated under standardised approaches	Credit risk	Operational risk	Market risk
	Counterparty credit risk	CVA	Securitisation

IRB approach to credit risk includes the proposed 1.1 IRB scaling factor.
There are certain asset classes or risk types that have common approaches for both IRB and standardised ADIs, such as operational risk.
CVA: credit valuation adjustment.

APRA intends to implement the capital floor without the Basel III transitional timeframe. The level of the floor will therefore be set at 72.5 per cent from 1 January 2023, rather than phasing-in the measure over a five-year period.

2.3 Leverage ratio

Consistent with the Basel III framework, APRA proposed introducing the leverage ratio as a minimum capital requirement, with a revised exposure measure calculation. APRA proposed applying a minimum leverage ratio requirement of 3.5 per cent to IRB ADIs and 3.0 per cent to standardised ADIs (excluding those ADIs eligible for inclusion in the simplified framework).

As part of its objective to apply greater proportionality, APRA is now proposing to only apply the leverage ratio to IRB ADIs. This approach aligns with APRA's current disclosure regime, with only IRB ADIs required to calculate and disclose the leverage ratio.

The leverage ratio is intended to operate as a backstop to risk-based capital requirements. APRA considers that it more usefully performs this function where there is the potential for low capital outcomes under internally modelled approaches, and for those ADIs that typically have larger off-balance sheet exposures in the form of derivatives and securities financing transactions (SFTs). Additionally, for internationally active banks, the leverage ratio provides an alternative measure of capital strength.

For standardised ADIs, APRA considers that the prudential benefits of applying a leverage ratio are outweighed by the regulatory costs. That said, if a standardised ADI becomes more complex and, for example, increases its activities offshore or materially increases its derivative or SFT exposures, APRA will retain the discretion to apply the leverage ratio to an individual ADI.

Amendments to the accompanying draft APS 110 reflect the proposals outlined above.

2.4 Other amendments

APRA is also proposing other amendments to APS 110, including:

- PCR: in addition to being able to set an ADI's PCR as a ratio requirement, APRA is including a provision that would also allow minimum capital requirements to be set as a dollar amount where this is deemed more appropriate (e.g. for certain newly licensed ADIs).
- Disclosure of PCR: consistent with longstanding practice and expectation, APRA is incorporating the requirement that ADIs must not publicly disclose their PCR.
- Drafting: a range of other drafting edits have been made to improve the clarity of the standard.

Chapter 3 - Simplified framework

This chapter outlines APRA's proposals for a simplified capital framework that will apply to small, less complex ADIs. It includes APRA's response to submissions to the June 2019 proposals, and outlines additional measures APRA is proposing to enhance proportionality.

3.1 Purpose

APRA's implementation of the capital framework is guided by the Basel Committee's internationally agreed framework. The Basel framework has been designed for internationally active banks, and since the Global Financial Crisis, has become increasingly complex. For small, domestic ADIs, the cost of these measures can outweigh the benefit to prudential safety. In response, APRA has proposed a 'simplified framework' that carves out small, less complex ADIs from segments of the broader capital framework and applies requirements more appropriate for their size and complexity.

3.2 Eligibility

APRA proposed that eligibility for the simplified framework would be determined through both a quantitative threshold and qualitative criteria. APRA proposed using a quantitative threshold of $15 billion of total assets applied at the highest level of consolidation. APRA proposed supplementing the quantitative threshold with qualitative criteria, which included the requirement that ADIs have simple and domestic activities. Further, foreign-owned ADIs and foreign ADIs would not be eligible for the simplified framework.

Comments received

Respondents raised concerns that the $15 billion quantitative threshold may not cover all mutual ADIs by 1 January 2022, which was the date of implementation of the broader capital framework at the time of consultation.

APRA's response

APRA is now proposing to increase the quantitative threshold to $20 billion in total assets, to ensure that more ADIs remain eligible for inclusion in the framework. APRA expects that the $20 billion threshold will cover all mutual ADIs, and provide sufficient scope for ADIs to continue to grow without needing to transition onto the broader capital framework.

The revised quantitative threshold will apply in combination with the previously proposed qualitative criteria, which require that the ADI:

- does not have any trading book activity, and has immaterial non-centrally cleared derivative exposures;
- conducts domestic activities only, with no offshore funding; and
- is not a foreign-owned ADI, foreign ADI or purchased payment facility provider.

Although all ADIs that meet the proposed criteria will automatically be subject to the simplified framework, APRA will retain the discretion to require a small ADI to use the more complex framework where appropriate. This may include application of the full capital framework, or application for certain types of risks (e.g. counterparty credit risk), based on the nature and risks associated with the ADI's business.

The draft APS 110 has been amended to include the definition of a small ADI, reflecting the revised eligibility criteria for the framework.

3.3 Scope of the simplified framework

Consistent with the objective of minimising regulatory burden, APRA is proposing to expand the scope of the simplified framework. APRA's revised proposals are detailed in Table 2.

Table 2. Proposals within the simplified framework

Risk area	June 2019 proposal	Current proposal
Operational risk	APRA proposed a simple, flat rate capital add-on of 10 per cent of total RWA.	No change proposed – APRA will continue to review the calibration using data from the next quantitative impact study to ensure the 10 per cent add-on remains appropriate.
Counterparty credit risk (CCR)	No CCR capital requirements; however, ADIs would still be subject to reporting requirements under *Reporting Standard ARS* 180.0 *Counterparty Credit Risk* (ARS 180.0).	APRA is now proposing to remove the requirement for small ADIs to report under ARS 180.0.
Interest rate risk in the banking book (IRRBB)	The revised *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book* (APS 117) proposed introducing qualitative risk management requirements and data reporting requirements for small ADIs who are not subject to an IRRBB capital charge.	APRA is now proposing to not extend the qualitative risk management requirements of APS 117 to small ADIs; however, reporting requirements will be retained so that supervisors are able to continue monitoring potential IRRBB risk.
Leverage ratio	No leverage ratio requirement; however, ADIs would still be required to report a limited number of items under *Reporting Standard ARS 110.1 Leverage Ratio* (ARS 110.1).	APRA is now proposing to remove the requirement for small ADIs to report under ARS 110.1.

Risk area	June 2019 proposal	Current proposal
Public disclosures	APRA proposed removing requirements for ADIs to make public disclosures under *Prudential Standard APS 330 Public Disclosure* (APS 330) and instead publish a centralised dashboard of key prudential measures on behalf of small ADIs. This proposal would require greater reliance on ADIs' own financial reporting for disclosures relating to remuneration and regulatory capital instruments.	APRA intends to consult further on these changes as part of its consultation on APS 330 in 2021.

Chapter 4 - Residential mortgages

This chapter details APRA's response to the treatment of residential mortgages under both the standardised and IRB approaches.

4.1 Standard mortgages

To be classified as a 'standard' mortgage, a loan must first satisfy minimum enforceability, serviceability and valuation criteria. APRA's proposed criteria for this purpose largely follow the Basel III framework.

Comments received

Respondents expressed concern with certain elements of APRA's proposals and recommended certain amendments:

- Serviceability: the interest rate buffer of 2.5 per cent should only be applied to consumer mortgage products and ADIs should be permitted to continue to apply other equivalent serviceability assessments to business loans secured by residential property.
- Valuations: the requirement that the property be 'readily marketable' will disproportionately affect ADIs lending in rural and regional areas. Additionally, for the purposes of calculating the loan-to-valuation ratio (LVR), revaluation should be permitted in circumstances beyond just a new loan application process.
- Mixed collateral: the exclusion of commercial property from the LVR calculation for residential mortgage exposures introduces inconsistencies given the interaction of this paragraph with the requirement to classify property exposures based on the 'predominant' security. All collateral should be recognised in the calculation of LVR, with the application of appropriate haircuts for different types of collateral.

APRA's response

In relation to some of the issues raised, APRA considers that these may be more appropriately addressed through guidance and so will be covered by the revised Prudential Practice Guide APG 112 Standardised Approach to Credit Risk (APG 112).

Serviceability

The Basel III framework requires the application of minimum serviceability criteria in classifying residential mortgages as either 'standard' or 'non-standard' loans. APRA had previously proposed various quantitative criteria to try and ensure some minimum level of consistency across the industry in this designation. This requirement is not, however, intended to replace ADIs' existing underwriting criteria for different types of loans. APRA expects that ADIs' serviceability assessments would be broader than what is proposed in APS 112.

The core requirement is that ADIs consider the impact of higher interest rates on the ability of the borrower to repay. APRA had previously proposed including the application of an

interest rate buffer of 2.5 per cent for residential mortgage exposures, but is now proposing to remove this requirement to provide greater flexibility in serviceability assessments. For example, for business loans secured by residential property, APRA expects that ADIs would be applying a higher serviceability buffer (or sensitised interest rate) given their higher risk profile. APRA will rely on supervisory guidance, by way of Prudential Practice Guide APG 223 Residential Mortgage Lending and the revised APG 112 to promote consistency in assessments by ADIs.

Valuations

APRA is proposing to remove the explicit requirement that the property is 'readily marketable' as this should already be accounted for in the valuation of the property. Given the requirement for property to be appraised independently using prudently conservative criteria, APRA expects that the location and condition of the property would be considered in determining the appropriate valuation.

APRA does not intend to expand the circumstances under which property revaluations will be permitted for LVR calculations. The requirement to maintain property values as at origination is intended to prevent ADIs artificially lowering LVR by obtaining new valuations when property prices are increasing. Similarly, ADIs are not required to revalue properties downwards during an economic downturn. Allowing revaluations as part of new loan applications is intended to give ADIs some flexibility to compete for their own customers and avoid churn across the industry, but APRA does not intend to permit this as part of a broader review process.

Mixed collateral

Historically, commercial property values have been more volatile through the economic cycle compared to residential property. While acknowledging that the proposed approach results in collateral for certain exposure types being excluded from the LVR calculation, APRA proposed this approach on the basis that it is simple, conservative and broadly in line with the Basel III framework. While the recognition of collateral under the standardised approach is generally simpler and less risk-sensitive than the IRB approach, APRA remains open to respondents suggesting a simple and conservative method of recognising commercial property collateral in these instances, as well as providing more details on the materiality of this issue.

4.2 IRB retail residential mortgage boundary

To qualify as a retail residential mortgage exposure under the IRB approach, consistent with the Basel III framework, APRA proposed that the exposure must be secured by residential property, the borrower must be an individual (natural person) and the loan must be managed by the ADI on a pooled basis. APRA also proposed applying the retail treatment to certain exposures to non-natural persons (e.g. trusts) where:

- the borrower operates solely for non-business or non-trading purposes;
- the borrower has fewer than five mortgaged residential properties; and
- the loan is guaranteed by an individual (natural person), or in the case of a trust, all trustees and beneficiaries are natural persons.

Comments received

Respondents did not support the proposal to exclude certain exposures to non-natural persons from the retail residential mortgage asset class. Respondents highlighted difficulties with accurately tracking the number of mortgaged properties, as ADIs will not be aware of mortgages held with other lenders and are reliant on borrower disclosures for this purpose. Respondents also noted that certain trusts would not meet the requirement for all trustees and beneficiaries to be natural persons, even though the trust had been established for personal purposes. Respondents noted that APRA's proposed approach is likely to introduce unwarranted operational complexity and recommended that the current definition continue to apply.

APRA's response

Acknowledging respondents' concerns, APRA is proposing to retain its current approach and define retail residential mortgage exposures as exposures (whether or not extended to individuals) that are:

- part of a large pool of exposures that are managed by the ADI on a pooled basis;
- partly or fully secured by residential properties; and
- not for business purposes.

4.3 Segmentation and calibration

For standard residential mortgages, rather than adopt the Basel III concept of 'material dependence' (i.e. the ability to service a mortgage materially depends on the cash flows generated by the property securing the loan), APRA proposed the following categories:

- lower risk owner-occupied, principal-and-interest loans; and
- higher risk loans, including all investor loans, interest-only loans and loans to small- and medium-sized enterprises (SMEs) secured by residential property.

This same segmentation would be applied to residential mortgages under both the standardised and IRB approaches, with the exception of SME loans secured by residential property as these are excluded from the IRB residential mortgage asset class. For the standardised approach, APRA proposed two risk weight schedules that varied by LVR. Under the IRB approach, APRA proposed that ADIs apply different multipliers to the RWA calculated using the Basel risk-weight formula.

Comments received

In relation to the proposed risk-weight schedule for the standardised approach, respondents recommended that the overall difference between high and low LVR risk weights be reduced. Respondents recommended that APRA adopt the Basel risk weights for owner-occupied, principal-and-interest loans.

Under the IRB approach, respondents were generally supportive of the use of multipliers as a simpler and more transparent way of implementing APRA's capital requirements. Regarding

the use of the two multipliers, respondents noted that the different risk profiles of owner-occupied, principal-and-interest mortgages and other mortgages are already captured, to varying degrees through IRB ADIs' risk estimates. The application of multipliers on top of these estimates would have the effect of further widening the gap between the segment risk weights, thereby amplifying the impact. This could result in a double counting of the same type of risk through both the application of the modelled estimates and the different multipliers. To minimise the distortive impacts across the portfolio, one respondent recommended that APRA apply a single fixed multiplier across the residential mortgage portfolio. Respondents also requested that APRA review the multipliers to ensure that the relative calibration reflects the underlying risk.

APRA's response

APRA is proposing to retain the segmentation based on lower risk owner-occupied, principal-and-interest mortgages and all other mortgages. For standardised ADIs, APRA considers that this segmentation is simpler to implement than the Basel concept of 'material dependence'. The proposed segmentation is also better aligned with APRA's supervisory actions on housing over the past five years.

Treatment of transitioning interest-only mortgages

APRA is proposing to further refine its segmentation in relation to the treatment of interest-only mortgages under both the standardised and IRB approaches. APRA considers that risk is heightened in the period immediately following a switch from interest-only repayments to higher minimum repayments on a principal-and-interest basis, with borrowers more likely to fall into arrears or default. To reflect this risk, APRA is proposing to require ADIs to continue to risk weight these loans according to the higher 'other residential mortgage' risk-weight schedule or multiplier for a period of six months following conversion to principal-and-interest repayments. APRA is also proposing that all interest-only residential mortgages with an interest-only period of greater than five years will be classified as 'non-standard' loans (see section 4.4.1 below).

Refinement of LVR buckets

Under the standardised approach, APRA is proposing to split the 60-80 per cent LVR bucket to recognise the different risk profile of loans in the 70-80 per cent LVR range versus the 60-70 per cent LVR range. At the high LVR end, APRA is proposing to reduce risk weights in the 80-90 per cent LVR range, and increase risk weights in the greater than 100 per cent LVR range, as compared to the June 2019 consultation. At the lower LVR end, consistent with the Basel III framework and APRA's previous consultations, the proposed minimum risk weight for residential mortgages under the standardised approach is 20 per cent. The revised risk-weight schedule is set out in Table 3.

Table 3. Indicative risk weights for residential mortgages

		RW %						
	LVR %	≤ 50	≤ 60	≤ 70	≤ 80	≤ 90	≤ 100	> 100
Standard, no LMI	Owner-occupied principal-and-interest mortgages	20	25	30	35	50	70	85
	Other residential mortgages	25	30	40	45	65	85	105

Multipliers under the IRB approach

Under the IRB approach, APRA intends to proceed with the application of two multipliers to ensure that the capital difference between the two segments remains broadly the same under both the standardised and IRB approaches. However, APRA has recalibrated the multipliers taking into account the double counting issues raised by respondents and the outcomes from the June 2019 QIS. The revised multipliers are set out in Table 4.

Table 4. Indicative multipliers under the IRB approach

Owner-occupied, principal-and-interest mortgages	1.4 x
Other residential mortgages	1.6 x

Risk-weight floor under the IRB approach

APRA is also proposing to introduce a risk-weight floor of 5 per cent for residential mortgage exposures under the IRB approach. The floor would be applied at the exposure level and after the relevant probability of default (PD), loss given default (LGD) and exposure at default (EAD) floors as well as the residential mortgage multipliers, but before the overall IRB scaling factor. The introduction of this floor is intended to limit the difference in capital outcomes between the standardised and IRB approaches for lower risk residential mortgage exposures.

APRA considers that 5 per cent is the appropriate calibration for the risk-weight floor after taking into consideration the differences in capital requirements between the standardised and IRB approaches that are not captured in risk weights. This includes the overall IRB scaling factor of 1.1, additional 150 basis point capital buffer requirement for IRB ADIs and the lower credit conversion factor (CCF) requirement of 40 per cent for standardised ADIs.

4.3.1 Community Housing

Under the standardised approach, the Basel III framework permits residential property exposures to public housing companies and not-for-profit associations regulated under national law to be excluded from classification as 'materially dependent' residential property exposures. APRA's current prudential framework does not set out a specific risk weight for community housing exposures. Rather, where these exposures are secured by residential property, they are risk-weighted based on LVR in the same way as other housing exposures. Under APRA's revised proposals, these exposures would be risk-weighted as 'other standard

mortgages', given they have different risk profiles compared to owner-occupied principal-and-interest mortgages.

Similarly, under the IRB approach, the Basel III framework includes an exception that allows exposures to associations or cooperatives that meet certain criteria to be treated as residential mortgages, rather than income-producing real estate (IPRE). Based on risk considerations, APRA considered it appropriate to retain its current approach which treats loans to public housing providers as IPRE.

Comments received

Respondents were concerned that APRA's proposed approach would increase capital requirements for community housing exposures, and adversely affect pricing and the supply of credit to the sector. Respondents requested that these exposures be eligible to be risk weighted as lower risk residential mortgages under the standardised approach and as retail residential mortgages under the IRB approach, for the following reasons:

- low-risk profiles – respondents asserted that APRA does not account for the low-risk profiles of public housing exposures. Rent for public housing is paid directly from Government welfare payments, which are stable and not typically impacted by the economic cycle. Additionally, the community housing sector is regulated by the National Regulatory System for Community Housing, which ensures providers are well governed, well managed and viable;
- deviation from Basel III – the Basel III framework includes an exception that allows public housing to be treated as a non-materially dependent residential mortgage under the standardised approach, and as a retail residential mortgage under the IRB approach. Respondents considered that APRA is unnecessarily deviating from Basel by not implementing these exceptions in the revised framework; and
- underlying social issue – higher capital requirements for ADIs with public housing exposures creates a disincentive to invest in public housing, which may lead to a reduced supply in public housing. APRA's proposal does not account for this underlying social issue.

Clarification was also sought on how the Government's support for the sector could be recognised.

APRA's response

APRA considers it appropriate to categorise public housing exposures as 'other' standard residential mortgages under the standardised approach and IPRE under the IRB approach. While APRA acknowledges that repayments are less likely to be affected by the economic cycle, there are other idiosyncratic risks particularly in relation to the operating requirements of the asset. Further, although respondents noted general Government support for the sector, APRA's understanding is that this is by way of funding grants rather than any explicit Government guarantees in the event of financial distress or default. APRA therefore considers that lending to public housing providers has a different risk profile to owner-occupied, principal-and-interest residential mortgages.

More broadly, APRA does not consider that its proposed treatment will lead to increases in capital requirements for loans to the sector. As outlined below in section 6.4, APRA is proposing to move IPRE exposures off the supervisory slotting approach and allow IRB ADIs to use internal models for this asset class. APRA expects that this will result in capital requirements decreasing for this portfolio relative to current requirements. To the extent that lending to community housing providers is lower risk, this should be reflected through lower PD estimates in IRB ADIs' internal models. APRA considers that these estimates will have a greater impact on capital requirements than the risk-weight function (IPRE versus residential retail).

APRA welcomes submissions that provide further evidence that the risk profiles of community housing exposures are similar to owner-occupied, principal-and-interest residential mortgages and therefore should receive a concessional risk weight. In particular, any data from ADIs on their loss experience with the sector would assist in setting the appropriate capital requirements.

4.4 Non-standard mortgages

For residential mortgages classified as 'non-standard' loans, APRA proposed applying a flat 100 per cent risk weight under both the standardised and IRB approaches. This would include any residential mortgages that do not meet minimum enforceability, valuation and serviceability criteria, as well as reverse mortgages, shared equity mortgages and loans to self-managed superannuation funds.

Comments received

Some respondents supported the flat risk weight of 100 per cent for 'non-standard' residential mortgages in light of the proposed definition. Other respondents continued to advocate for more granular risk weight buckets that recognise LVR and lenders' mortgage insurance (LMI), or exceptions for certain products such as bridging finance.

One respondent also recommended that APRA align the criteria for reclassifying a 'non-standard' loan as 'standard' with the requirements for performing and non-performing loans in *Prudential Standard APS 220 Credit Risk Management* (APS 220).

APRA's response

APRA does not expect that non-standard loans will form a material portion of the residential mortgage portfolio of ADIs. For this reason, a simple approach that can be consistently applied across all ADIs is preferred. APRA is therefore proposing to retain the 100 per cent risk weight for non-standard mortgage exposures under both the standardised and IRB approaches. Carve-outs for certain products or discounts for LMI will not be recognised.

The criteria for when a non-standard residential mortgage can be reclassified as a standard loan has been amended as suggested. Where a non-standard mortgage does not meet serviceability requirements at origination, an ADI may reclassify it as a standard loan when it has been performing consecutively for 36 months. ADIs will not be permitted to re-classify loans with interest-only periods greater than five years, or loans that otherwise do not meet enforceability or valuation criteria, as standard loans.

4.4.1 Interest-only residential mortgages

Subsequent to the June 2019 consultation, APRA has further considered the treatment of interest-only loans with an interest-only period greater than five years. APRA is proposing that these exposures will also be classified as 'non-standard' loans.

Interest-only borrowers face a longer period of higher indebtedness, which increases their risk of falling into negative equity if house prices fall. Borrowers may use interest-only loans to maximise leverage, or for short-term affordability reasons. Borrowers may also face significant 'repayment shock' when the interest-only period ends and regular payments increase. This repayment shock is likely to be more acute when interest rates are low. The risks inherent in interest-only lending are likely to be exacerbated by longer interest-only periods. APRA therefore considers that the non-standard classification is a better representation of the risks within these loans. A non-standard classification will result in a significantly higher risk weight of 100 per cent, compared to APRA's previous proposal.

4.5 Off-balance sheet mortgage exposures

APRA proposed aligning CCFs under the standardised and IRB approaches, including a 100 per cent CCF for residential mortgages. While consistent with the current modelled estimates of IRB ADIs, this would result in a significant increase from the current ~0-50 per cent CCF for standardised ADIs.

Comments received

A number of respondents commented that the proposed CCF of 100 per cent for residential mortgages is overly conservative and does not reflect the actual usage of these credit lines. While acknowledging that there was some risk of redraw, respondents considered that a 40 per cent CCF, as per the Basel III framework, was appropriate for residential mortgages. Most respondents requested that APRA adopt the Basel III CCFs.

APRA's response

APRA is proposing to adopt the following CCFs for off-balance sheet residential mortgage exposures, which differ between the standardised and IRB approaches.

Table 5. CCFs for residential mortgage exposures

	CCF (%)
Standardised approach	40
IRB approach	100

APRA is proposing to maintain the 100 per cent CCF for residential mortgage exposures for IRB ADIs.[1] This estimate remains appropriate based on the empirical evidence provided to

[1] Note that this CCF only applies to non-revolving residential mortgage exposures. APRA is proposing to continue to allow IRB ADIs to model EAD for revolving residential mortgage exposures.

APRA in its assessment of ADIs' EAD models. Borrowers do not typically enter default until they have fully drawn down on their available limit, including any prepayments ahead of their scheduled balance.

Under the standardised approach, APRA is proposing a lower CCF of 40 per cent for residential mortgages, consistent with the Basel III framework. For residential mortgages, prepayments make up the majority of off-balance sheet exposures. Prepaid loans are less likely to result in losses, given borrowers have demonstrated a greater capacity to repay loans. Under the IRB approach, prepayment is generally recognised through a lower PD estimate. To recognise the reduction in risk from prepayments which is not otherwise recognised in risk weights, APRA considers that a concessional CCF treatment under the standardised approach is appropriate. The application of a concessional CCF will also contribute to ensuring the difference in residential mortgage capital requirements between the standardised and IRB approaches remains appropriate.

4.6 Lenders' mortgage insurance

APRA intends to continue to recognise a capital benefit for residential mortgages with LMI with an LVR greater than 80 per cent. Under the standardised approach, APRA proposed recognising LMI through the risk-weight schedule, such that higher risk weights would apply to loans with an LVR greater than 80 per cent that do not have LMI. Under the IRB approach, APRA proposed standardising the recognition of LMI through the application of a 20 per cent reduction to LGD estimates for exposures with an LVR greater than 80 per cent (subject to the ADI having an APRA-approved LGD model and the 10 per cent LGD floor).

Comments received

Respondents recommended a consistent capital benefit for loans with LMI across the standardised and IRB approaches, and that this should be in the range of 30-50 per cent. Some respondents also suggested that a capital benefit should be recognised on loans with LMI with an LVR less than 80 per cent, and under the IRB approach where ADIs do not have an APRA-approved LGD model.

Certain respondents also recommended that LMI recognition should be calibrated to provide regulated system capital neutrality, so that lenders that choose not to use LMI should be required to hold additional capital equivalent to the value of LMI provider capital forgone as a result. There was concern from some respondents that the proposed changes may negatively impact the viability of the LMI industry.

Certain respondents recommended that APRA introduce different levels of capital benefit to reflect differences in LMI products and levels of cover. Some respondents also recommended that APRA recognise a broader range of insurance options, including pooled insurance, captive insurance and self-insurance, to reduce structural concentration risks to LMI providers.

APRA's response

APRA is proposing to consistently apply a 20 per cent discount for loans with LMI across the standardised and IRB approaches. This reduction only applies to residential mortgage exposures with an LVR greater than 80 per cent. The risk weights for defaulted residential

mortgages with LMI have also been amended to reflect a 20 per cent discount under the standardised approach. Although there is slightly less recognition for LMI under the standardised approach relative to the current framework, greater recognition in the IRB framework will be permitted for those ADIs with approved LGD models. Where ADIs do not have approved LGD models, APRA is proposing a simple application of the LGD floor that does not recognise risk factors, including LMI. APRA considers that its proposals will broaden the availability of LMI, from a capital recognition perspective, to the entire banking industry and do so in a more consistent manner.

APRA considers that a 20 per cent discount for residential mortgages with LMI cover remains appropriate. In determining the appropriate level of the discount, APRA's considerations include that:

- ADIs hold capital directly to absorb losses in their lending portfolios and a fundamental principle of APRA's capital framework for ADIs is that capital must be freely available to absorb losses. In this regard, LMI is an insurance product; it is not a guarantee. Protection provided by LMI is indirectly available to the banking system as it is subject to a claims process that may be uncertain, lengthy or rejected, and so is not a perfect substitute for capital held directly by an ADI. Moreover, capital held by an LMI provider is not fungible in the same way as capital held directly by the ADI.

- The proposed discount on risk-weight outcomes recognises the different levels of capital strength between ADIs and LMI providers, as evidenced by their external credit ratings. For the largest ADIs, it would be imprudent to encourage them to build a significant reliance on a lower-rated counterparty.

- LMI recovery claims have the potential to become a material concentration risk in periods of stress. Unlike other concentrated exposures, ADIs are not subject to limits for their large exposures to LMI providers. Instead, APRA has addressed this concentration risk as part of the level of capital recognition of LMI in mortgage risk-weight outcomes.

APRA is balancing increased capital for housing held by ADIs, with continued recognition of LMI in the ADI capital framework. Further recognition of LMI would dampen the loss absorbing capacity of the financial system for risks in the residential mortgage market and is contrary to APRA's primary objective of calibrating the ADI capital framework to an 'unquestionably strong' level. APRA considers that the revised capital framework will still provide sufficient incentive for ADIs to use LMI where appropriate. APRA also notes that since the introduction of the Basel II framework in 2008, LMI has been used more broadly by ADIs as a risk management tool, even in the absence of capital incentives.

APRA is not proposing to introduce different levels of capital recognition for different LMI products or levels of coverage. APRA is retaining a principles-based approach that provides simple and consistent recognition across the industry. However, APRA will reassess the capital treatment of LMI if the nature or features of the product offered to ADIs changes. APRA is also not proposing to broaden the types of insurance products that may be recognised for the purpose of reducing regulatory capital requirements. Where these products meet the criteria for recognition as an eligible credit risk mitigation technique a capital benefit may be recognised, but APRA does not intend to modify the relevant criteria, or approve bespoke contracts or products for this purpose.

Chapter 5 - Other exposures under the standardised approach

This chapter details APRA's response to the treatment of all other exposures under the standardised approach. The draft revised APS 112 accompanying this response paper has been marked-up relative to the June 2019 consultation version.

In addition to those issues specifically highlighted below, APRA has also made a number of other drafting amendments to APS 112 in response to issues raised by respondents. APRA considers that certain other issues raised may be more appropriately dealt with through guidance, and will be included as part of the revised APG 112.

5.1 Commercial property

Similar to residential property, commercial property exposures must be classified as either a 'standard' or 'non-standard' loan. For this purpose, the same minimum requirements relating to enforceability, serviceability and valuations apply. To assess the borrower's ability to repay for commercial property dependent on cash flows generated by the property, APRA proposed requiring an assessment of the tenancy profile over a period up to at least one year past the maturity of the loan. APRA proposed applying the same valuation requirements to both residential property and commercial property, consistent with the approach under the Basel III framework (see section 4.1 above).

Comments received

Respondents highlighted that serviceability assessments of commercial property will generally include considerations that are broader than tenancy profile (e.g. stability of cash flows, weighted average lease expiry, creditworthiness and diversification of tenants, quality of the property, vacancy rates, outgoings and expenses). Reliance on the narrow criterion of tenancy profile may lead borrowers to seek short-term funding and increase churn. Respondents therefore requested removal of this requirement to allow ADIs to continue to exercise flexibility in commercial property assessments.

Respondents noted that commercial property assets are subject to greater diversity of purpose and function, which requires predominantly expert valuations. Maintaining regular valuations is a critical input in determining the ongoing credit position of each borrower. Respondents recommended that where ADIs use expert valuations (in contrast to model or index-based valuations), these be incorporated into LVRs so that the APS 112 risk weighting best reflects the credit position of individual borrowers. If more dynamic LVRs are not permitted, then transition arrangements should be implemented to allow IRB ADIs to implement systems to differentiate between valuations at origination and current valuations in risk-weighting calculations.

Respondents also requested that modifications made to contractual arrangements (rather than the property itself), such as adjustments to the lease or quality of the tenant, be recognised for the purpose of updated valuations.

APRA's response

APRA is not proposing to remove the requirement that ADIs assess tenancy profile as a minimum criterion to designate a commercial property loan as 'standard'. Similar to residential mortgages, APRA expects that ADIs' assessments of the borrower's ability to repay would be broader than the minimum criteria included in APS 112.

Consistent with the Basel III framework, APRA intends to proceed with its proposal to require ADIs use the valuation of the commercial property at origination. However, APRA will allow modifications to contractual arrangements to be recognised as an increase in value for commercial property exposures. APRA will also grandfather the requirements for existing exposures, such that the ability to repay criteria does not need to be applied to the backbook, and the value at origination will only need to be applied to commercial property exposures originated after 1 January 2023.

5.2 Land acquisition, development and construction

APRA proposed to adopt the Basel III land acquisition, development and construction (ADC) asset class under the standardised approach. ADC exposures must be risk-weighted at 150 per cent unless they meet specific criteria, in relation to pre-sales and equity at risk, in which case a concessional risk weight of 100 per cent may be applied. For the purpose of the concessional risk weight, APRA proposed qualifying pre-sales equal to 100 per cent of the exposure amount, and debt to qualifying development costs less than 75 per cent.

Comments received

Respondents noted that the requirements for the concessional risk weight do not reflect the relative risk of different structures and fail to consider:

- build-to-hold structures (both residential and commercial), where the intention is to develop an investable asset that is subsequently leased. These structures have different risk considerations to typical residential developments reliant on pre-sales and will be penalised where the pre-sale criteria cannot be met;
- the benefit of lower leverage which may provide a buffer if residual stock was held on completion; and
- other structural enhancements, such as sponsor guarantees.

Respondents recommended that the requirement for 100 per cent pre-sales and less than 75 per cent development costs should be removed, and suggested implementing a broader credit assessment which would include consideration of other mitigating factors and provide a more complete view of the borrower.

Respondents also requested a broader list of exemptions from treatment as ADC exposures. Specifically, respondents requested that property being constructed by investors for rental purposes be exempt from ADC treatment. Other respondents requested that the exemption be expanded to commercial property and low LVR properties under construction.

APRA's response

APRA considers it appropriate to align with the Basel III framework and implement the ADC criteria as outlined in the June 2019 response paper. As ADC exposures are generally higher risk compared to developed property exposures, any concessional risk weight for better quality residential development should be restrictive. APRA considers that the proposed equity at risk requirement of 100 per cent pre-sales and less than 75 per cent debt to qualifying development costs remain appropriate for this purpose.

APRA does not intend to deviate from the Basel III framework and broaden the exemptions from ADC treatment to include commercial property, low LVR properties, or property being constructed by investors for rental purposes. APRA considers the current exceptions for agricultural or forestry purposes, or residential property where an individual is constructing their primary residence, remain appropriate as limited exclusions.

5.3 Bank exposures

APRA's proposals for bank exposures include adopting the Basel III risk weights for rated bank exposures, but not the criteria and approach for unrated bank exposures. APRA considers that the Basel framework's Standardised Credit Risk Assessment (SCRA) approach is difficult to apply in a consistent manner and, so, for the purposes of simplicity and consistency, proposed retaining a flat risk weight of 20 per cent for short-term exposures and 50 per cent for long-term exposures consistent with the current APS 112 risk weights. Although APRA does not intend to adopt the SCRA approach, it considers that the application of a sovereign floor for unrated bank exposures remains appropriate. This ensures that unrated bank exposures cannot be assigned a risk weight lower than that of the sovereign in the jurisdiction in which the bank is incorporated. This requirement, which is consistent with the current approach under APS 112, has been included in the accompanying revised draft of the standard.

Consistent with the Basel III framework, APRA has also amended the draft APS 112 to reflect the requirement that ADIs must not use external ratings that include uplifts for implicit government support. The risk weight for these exposures would instead be assigned based on the stand-alone credit rating of the ADI or bank. APRA would welcome feedback from respondents on whether there are practical difficulties in implementing this proposed approach.

5.4 SME exposures

For SME exposures not secured by real property, APRA proposed a more granular risk-weight schedule (75 per cent, 85 per cent and 100 per cent risk weight buckets) based on the recognition of certain types of eligible collateral. APRA considered that this approach was better aligned to risk than the Basel segmentation which is based on an exposure size threshold and diversification requirement.

Comments received

While respondents were supportive of a more granular risk weight treatment for SME exposures not secured by real property, various complexities with the proposed approach

were highlighted. Respondents raised concerns with the proposed collateral requirements, including:

- the proposed list of eligible collateral was too narrow and should be broadened to include other physical collateral as well as business receivables and licences;
- using the market value of collateral would be difficult to implement in certain circumstances; and
- as it is common that collateral not related to the business is often pledged as security, the requirement that the collateral be directly related to the business would preclude the recognition of collateral that would otherwise be eligible.

Several respondents expressed a preference for APRA to align with the Basel III framework for SME exposures.

APRA's response

Given the increased focus on comparability and the complexities associated with the recognition of collateral, APRA is now proposing to adopt the Basel III treatment for SMEs. Exposures will be risk-weighted based on whether they meet the criteria for classification as SME retail or SME corporate. Exposures that meet the conditions for inclusion as SME retail may be risk-weighted at 75 per cent. Exposures that do not meet the conditions for SME retail treatment would be treated as SME corporate exposures and risk-weighted at 85 per cent. This approach results in a considerable reduction in risk weights from the current 100 per cent requirement.

5.5 Specialised lending

Consistent with Basel III, APRA is introducing a specialised lending asset class under the standardised approach. The specialised lending asset class includes the three sub-asset classes of project finance, object finance and commodities finance.

Comments received

Respondents considered the criteria for the classification of project finance exposures too narrow; in particular, the separation of project finance exposures into 'operational phase' and 'high quality'. Respondents considered the requirement that an entity has declining long-term debt to be considered in its 'operational phase' was too limiting as some working capital lines may never amortise.

Other respondents raised concerns over requirements for project finance exposures to be classified as 'high quality'. Respondents considered the requirement that a project finance entity's revenue depends on one main counterparty to be restrictive, highlighting that multiple counterparties provide diversification benefits that improve an exposure's quality. Other concerns were raised regarding the quantity of requirements, with respondents suggesting an exposure need not meet all requirements to be considered 'high quality'.

APRA's response

APRA agrees with respondents' comments that the Basel III project finance criteria is not well suited to the Australian market. As a simple alternative, APRA is proposing to remove the different categories of project finance exposures and replace these with a single category risk-weighted at 110 per cent. APRA considers that this risk weight is appropriate based on the June 2019 QIS data, and to also ensure broad equivalence with the Basel framework for the project finance portfolio.

APRA is open to reverting to the Basel III approach of different risk-weight buckets for the different phases and quality of project finance exposures; however, APRA will not modify the criteria as set out in the Basel III requirements for this purpose.

5.6 Retail exposures

APRA proposed a risk weight of 125 per cent for most retail exposures based on the potential loss rates of the portfolio, with the exception of:

- personal loans secured by vehicles, for which a risk weight of 100 per cent was proposed on the basis that the presence of physical collateral mitigates losses in the event of default; and
- credit cards, for which a 75 per cent risk weight was proposed.

These proposals remained higher than those included in the Basel III framework. Basel III allows retail exposures to be risk-weighted at 45 per cent (regulatory retail transactors), 75 per cent (other regulatory retail) or 100 per cent (other retail).

Comments received

Respondents considered that the proposed risk weight for 'other retail' exposures was too high. Respondents recommended that APRA adopt the Basel III category of 'regulatory retail' and corresponding risk weights, which would allow eligible exposures to be risk-weighted at 45 per cent and 75 per cent; with all other retail exposures to be risk-weighted at 100 per cent. One respondent also recommended that the risk weight for secured auto-loans be further reduced from 100 per cent to 85 per cent.

APRA's response

APRA does not intend to adopt the 'regulatory retail' concept or risk weights under the standardised approach. APRA considers that risk weights of 45 per cent and 75 per cent are too low relative to the potential for loss in these portfolios. However, APRA is proposing to move to an approach closer to the Basel III framework. Consistent with its earlier proposal, APRA proposes to risk-weight credit cards at 75 per cent. APRA is also proposing to reduce the risk weights for all other retail exposures from 125 per cent to 100 per cent, consistent with the current approach under APS 112. Given this reduction in risk weight from 125 per cent, APRA is no longer proposing to apply a different risk weight to auto-loans.

5.7 Margin lending

APRA proposed to retain its current approach of risk-weighting margin lending exposures at 20 per cent, and expanded eligible collateral for this purpose to include unlisted managed funds with a high level of liquidity and redemption characteristics. Instruments that are not eligible for the 20 per cent risk weight would be risk-weighted at 100 per cent under the standardised approach.

Comments received

Respondents were concerned that the proposed changes to CCFs may have unintentionally impacted the margin lending asset class. In particular, respondents sought clarification of the treatment of undrawn margin lending limits, as the current approach is to treat the undrawn portion as uncommitted limits.

APRA's response

Consistent with the treatment of 'other commitments', the undrawn portion of a margin lending exposure would receive a 40 per cent CCF, under both the standardised and IRB approaches. APRA does not consider that these exposures will meet the criteria to be considered uncommitted facilities in the revised framework.

5.8 Subordinated debt

APRA proposed adopting the Basel III risk weight of 150 per cent for holdings of subordinated debt issued by commercial (non-financial) entities. APRA also proposed to extend the definition of subordination such that it would include any facility:

- that is expressly subordinated to another facility;
- that is structurally subordinated as the borrower has insufficient cash flows or assets from its own operations to meet its debt obligations (i.e. debt issued by holding companies); or
- where the ADI does not have a priority claim on the borrower's assets in the event of external administration or liquidation proceedings.

Comments received

Respondents raised concerns regarding the proposed extension of the definition to exposures that are subject to structural or collateral subordination. For structural subordination, respondents noted that the definition does not distinguish between structures where there are material creditors ranking ahead of the facility provided by the ADI and structures where there are no (or immaterial) creditors ranking ahead of the ADI's facility. For collateral subordination, respondents noted that the proposed definition would apply to a wide range of facilities regardless of the materiality of any existing claim. A more risk-sensitive definition would consider other characteristics such as the relative value and quality of the borrower's assets, the volatility of that value under different market conditions and the level of leverage. While these factors may be appropriate to consider under an advanced IRB (AIRB) approach, they are arguably too complex for inclusion in the standardised approach.

APRA's response

APRA has reconsidered its proposal to extend the definition of subordinated debt to include structural and collateral subordination. Under the standardised approach, APRA has simplified the proposed definition to only refer to facilities that are expressly subordinated to another facility. However, APRA will still require IRB ADIs to apply a broader definition of subordinated debt (see section 6.6).

5.9 Leases

APRA has previously raised prudential concerns over the capital treatment of leased assets. In particular, APRA considers that the current treatment does not capture the asset valuation and concentration risk that might arise where an ADI, as lessor, maintains a significant operating lease portfolio. Considering the broad nature of this asset class, APRA proposed to:

- retain the current 100 per cent risk weight where an ADI's aggregate leasing assets are below a threshold of 10 per cent of Tier 1 Capital; and
- assign a 250 per cent risk weight for exposures above this threshold.

Comments received

Respondents sought clarification on the scope of the proposed requirements to operating leases. Respondents suggested that the requirements in APS 112 be redrafted to refer to the 'aggregate residual value risk' rather than the 'aggregate lease exposures'. The reference to residual value risk would align with the approach under the Basel III framework by applying the 250 per cent risk weight only to residual risk exposures, rather than to all leases.

APRA's response

APRA has amended the draft APS 112 to clarify the scope of the proposed requirements. The 250 per cent risk weight will only apply to those exposures where an ADI is acting as lessor and is exposed to residual value risk.

5.10 Exposures through a third party

APRA proposed applying a higher risk weight of 150 per cent to credit risk exposures incurred through a third party, such as peer-to-peer lending platforms. This proposal followed supervisory observations of an increasing number of ADIs providing loan facilities to third-party platforms. APRA proposed a higher risk weight for these exposures, given certain structural characteristics.

Comments received

Most respondents noted that the proposed drafting would capture a broader range of exposures than is likely intended (e.g. securitisations, subscription finance facilities, direct lending to third-party lenders and purchased portfolios). More broadly, respondents did not support the application of a higher risk weight to these exposures, stating that the risk was mitigated by the new APS 220 requirement to undertake due diligence. Additionally, the flat

150 per cent risk weight ignores the risk of the underlying exposure, such that exposures secured by property would receive the same risk weight as unsecured loans.

If retained, respondents suggested applying a multiplier to the underlying exposure rather than a flat risk weight to recognise the different risk profiles of the underlying assets. Respondents alternatively suggested that APRA impose capital charges under Pillar 2 where it has concerns about an individual ADI's exposures to these arrangements, rather than applying an increase across the industry.

APRA's response

APRA considers that a higher risk weight of 150 per cent for these exposures remains appropriate. APRA's principal concerns with these arrangements are that:

- ADIs are committing funding to third parties, but do not have direct recourse to these third parties (or underlying borrowers in some arrangements) in the event of default;
- ADIs are not assessing the credit risk of the underlying borrowers according to their own credit risk policies and processes. Opportunities for hindsight review are also limited; and
- ADIs do not have the ability to put the underlying borrower into default or administer the workout process.

While most lending through these arrangements appears to be unsecured personal loans, APRA does not consider that any secured lending should get the benefit of a lower risk weight when the ADI does not have direct and unequivocal access rights to the collateral. APRA also does not consider that these risks are mitigated by ADIs undertaking due diligence.

Acknowledging respondent's comments that the current wording in APS 112 is too broad, APRA is proposing to refine the requirement to better reflect those characteristics considered to give rise to the higher risk profile. On this basis, APRA does not consider that securitisation exposures, subscription finance facilities, direct lending to third-party lenders, or purchased portfolios of assets would be captured. APRA will also include additional guidance as to how ADI's should be interpreting and applying this requirement in the revised APG 112.

5.11 Risk-weight multiplier for exposures with currency mismatch

Consistent with the Basel III framework, APRA proposed introducing the requirement to apply a multiplier of 1.5 to the applicable risk weight for any unhedged retail and residential property exposures to individuals where the lending currency differs from the currency of the borrower's income.

Comments received

Respondents noted that this proposal would be materially difficult to operationalise and introduce significant complexity (system and data upgrades to capture all data elements and

connect these to natural or financial hedges) for what is likely to be very little benefit. Respondents suggested that APRA allow ADIs to apply haircuts to foreign income instead of requiring application of the multiplier.

APRA's response

APRA is proposing to retain the requirement to apply a risk weight multiplier, to ensure consistency with the Basel III framework. APRA considers that the application of a single multiplier is simpler than having to prescribe various haircuts for different currencies. ADIs will only be required to apply the multiplier to relevant exposures originated after 1 January 2023.

5.12 Other off-balance sheet exposures

5.12.1 Definition of commitment

APRA proposed to adopt the Basel III definition of commitment such that a CCF must be applied to any credit exposure that has been offered by an ADI and accepted by the borrower. APRA also proposed to exercise the national discretion to exclude certain arrangements from the definition of a commitment, where:

- the ADI receives no fees or commissions to establish or maintain the arrangement;
- the borrower is required to apply to the ADI for the initial and each subsequent drawdown;
- the ADI has full authority over the decision to grant each drawdown application; and
- the ADI's decision on the execution of each drawdown is only made after assessing the creditworthiness of the borrower immediately prior to drawdown.

APRA also proposed removing the unconditionally cancellable category as a large number of arrangements that would have otherwise fallen into this category are now likely to be exempt from the definition of commitment, given the exercise of the national discretion.

Comments received

Respondents supported APRA's exercise of the national discretion to exempt certain arrangements from the definition of a commitment. A couple of respondents sought clarification on whether the requirement that the borrower be a corporate counterparty included SMEs. Respondents also requested further guidance on whether specific types of arrangements would fall within the exemption, the types of fee payments that would trigger classification as a commitment and the requirement to assess the creditworthiness of the borrower immediately prior to drawdown. One respondent recommended that acceptance, for the purpose of determining when a commitment comes into existence, exclude arrangements subject to material conditions precedent.

One respondent also recommended that APRA retain the unconditionally cancellable category for wholesale counterparties, and apply a 10 per cent CCF in line with the Basel III framework.

APRA's response

APRA has retained the Basel criteria for defining a commitment, and will provide further guidance in the revised APG 112 on the interpretation of the relevant criteria.

APRA's understanding of industry practice is that the types of arrangements that are likely to meet the exemption criteria are lending facilities to larger corporate clients and trade finance exposures. While SMEs are considered corporate counterparties (with the exception of SME retail exposures), APRA questions whether the extension of these conditions to SME loans is appropriate.

APRA does not intend to re-introduce the unconditionally cancellable category of commitment. APRA's observation of the current application of this category of commitment is that it has been applied inconsistently across the industry and inappropriately applied to facilities that are not unconditionally cancellable in practice. Given APRA will exercise the national discretion to exclude certain arrangements from the definition of a commitment, and the proposed recalibration of corporate CCFs, APRA does not consider that the inclusion of this category is warranted.

5.12.2 Calibration of credit conversion factors

APRA proposed to adopt the Basel III CCFs, with the exception of 'other commitments'. Rather than applying a 40 per cent CCF, APRA proposed to adopt CCFs in the range of 50 to 100 per cent based on counterparty and product type. This approach was considered to better align with the observed risks of these exposures.

APRA also proposed to more closely align CCFs between the standardised and IRB approaches, which would result in increased capital requirements for some products which are currently assigned a zero per cent CCF under the standardised approach.

Comments received

Respondents highlighted that the proposed CCFs were materially higher than the Basel III CCFs and would increase the complexity of international capital comparisons.

A number of respondents sought further clarification on the scope of 'short-term self-liquidating trade letters of credit arising from the movement of goods' for the purpose of applying a 20 per cent CCF. Some respondents suggested that the 20 per cent CCF should be extended to all trade products.

One respondent recommended that APRA retain the requirement that allows for the application of the lower of two applicable CCFs.

APRA's response

APRA is now proposing to align with the Basel III framework and apply a 40 per cent CCF to all 'other commitments' under the standardised approach. APRA will continue to require the application of higher CCFs for non-revolving retail exposures under the IRB approach (see section 6.7).

For trade finance products, APRA is not proposing to deviate from the Basel III requirement that limits the 20 per cent CCF to short-term self-liquidating trade letters of credit.

APRA is also proposing to re-introduce the requirement that allows ADIs to apply the lower of two applicable CCFs.

5.13 Defaulted exposures

APRA proposed to simplify the current treatment of defaulted exposures and apply a consistent definition of default across the standardised and IRB approaches. Under the standardised approach, APRA proposed to adopt the following risk weights:

- 100 per cent for residential mortgages without LMI; and
- 90 per cent for residential mortgages covered by eligible LMI.

Consistent with current requirements, all other defaulted exposures would be assigned a risk weight of 100 per cent where a specific provision has been raised that is at least 20 per cent of the outstanding exposure amount, or 150 per cent where the provision is less than 20 per cent.

Comments received

Respondents considered the 90 per cent risk weight for defaulted residential mortgage exposures with LMI was overly conservative and not representative of risk. Respondents noted the approach was not consistent with APRA's recognition of LMI for performing loans.

Respondents also requested that APRA align the definition of default, non-performing and related exit criteria between APS 112, APS 113 and APS 220.

APRA's response

APRA is now proposing to segment defaulted residential mortgage exposures consistently with performing exposures. Risk weights for defaulted residential mortgages with LMI will also receive a 20 per cent discount, consistent with the revised treatment of performing residential mortgage exposures with LMI. The revised risk weights are set out in Table 6 below.

Table 6. Defaulted residential mortgages

	Risk weight (%)
Owner-occupied principal-and-interest residential mortgage with LMI	80
Owner-occupied principal-and-interest residential mortgage without LMI	100
Other residential mortgage with LMI	95
Other residential mortgage without LMI	120
Non-standard residential mortgage	150

APRA is also proposing to align the definition of default, non-performing and conditions for exit between APS 112, APS 113 and APS 220. The definition of default and related exit

conditions are now included in the revised APS 220, which APRA finalised in December 2019.[2] The draft revised APS 112 and APS 113 cross-reference the relevant APS 220 requirements.

5.14 Securities financing transactions

Consistent with the Basel III framework, APRA proposed introducing minimum haircut floors for SFTs. The haircut floors aim to ensure that when an ADI uses non-centrally cleared SFTs to lend cash or high quality securities to non-bank counterparties, the value of the collateral received by the ADI (after applying a specified minimum haircut) exceeds the value of the cash or high quality securities lent by the ADI.

Comments received

Respondents sought clarification on the scope of application of the minimum haircut floors. Specifically, how the requirement that the floors apply to 'counterparties who are not supervised by a regulator that imposes prudential requirements consistent with international norms' should be interpreted.

Respondents also expressed concern that the implementation of the minimum haircut floors before international peers would place Australian ADIs at a competitive disadvantage within the international market. Respondents recommended that APRA not implement the reforms until after such time as other jurisdictions with significant exposures. One respondent recommended that APRA not implement the haircut floors, as it discourages ADIs from secured lending given the capital cliff effect when the floor is breached. It also reduces the diversity of counterparties and increases concentration amongst prudentially regulated entities.

APRA's response

The minimum haircut floors for SFTs introduce considerable complexity to address a risk that APRA does not consider to be material for Australian ADIs. Acknowledging respondents' concerns that Australia should not be a market leader in implementing these reforms, APRA will continue to monitor international developments, but does not intend to proceed with implementation at this time.

To the extent that changes to the current standard are required at a later date to address the risk of SFTs with non-bank counterparties, APRA's preference would be to adopt a simpler method of targeting the risk, such as through the application of higher supervisory haircuts for exposures to non-bank counterparties.

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[2] See 'Proposed revisions to the credit risk management framework for authorised deposit-taking institutions' (December 2019) https://www.apra.gov.au/proposed-revisions-to-credit-risk-management-framework-for-authorised-deposit-taking-institutions.

Chapter 6 - IRB proposals

This chapter details APRA's response to revisions to the IRB approach as initially proposed in the February 2018 discussion paper, and also details other changes to APS 113 to implement the Basel III framework. As APS 113 has been significantly revised, both in terms of its structure and specific requirements, a tracked-changes version of the standard relative to the in-force version has not been released with this response paper.

6.1 IRB scaling factor

While the Basel III framework has removed the current 1.06 IRB scaling factor, APRA is proposing to include an IRB scaling factor of 1.1 as part of calibrating to outcomes consistent with the 'unquestionably strong' capital benchmarks. This scaling factor also supports aggregate IRB RWA being calibrated above the capital floor and, along with other measures, means that the capital floor will not be binding at the system level. As noted above, the capital floor is intended to operate as a backstop measure, rather than replace IRB estimates.

6.2 Treatment of offshore exposures

APRA proposed applying its IRB requirements to any exposures of overseas banking subsidiaries that form part of the Level 2 group. This would mean that any scaling factors or adjustments to correlation factors that are applied to domestic exposures would also apply to offshore exposures.

Comments received

Respondents were supportive of APRA's prudential standards applying to all exposures regardless of jurisdiction and recommended that APRA apply the same IRB requirements for offshore exposures as for domestic exposures. Respondents were not supportive of a hybrid approach whereby foreign-regulator prescribed input parameters are incorporated into APRA-approved models.

APRA's response

APRA is proposing that the same IRB requirements are applied to offshore exposures, with the exception of exposures in New Zealand. APRA has further considered the merits of three broad approaches for the calculation of RWA and expected loss for New Zealand exposures at Level 2:

- option one: RWA is calculated as per the Reserve Bank of New Zealand's (RBNZ) rules and estimates;
- option two: RWA is calculated as per APRA rules, but uses RBNZ-approved PD, LGD and EAD estimates; and
- option three: RWA is calculated as per APRA rules and APRA-approved PD, LGD and EAD estimates that may differ to RBNZ-approved estimates.

Currently, APRA is applying the second of these approaches. Over the years, as both APRA and RBNZ have introduced different adjustments to the Basel framework within both rules and estimates, this approach has become increasingly untenable to maintain without inconsistent outcomes.

To simplify capital calculations, and in turn, capital floor calculations, APRA is proposing that RWA for the New Zealand banking subsidiaries of ADIs be calculated under the RBNZ's rules for the determination of Level 2 group capital requirements (i.e. option one). This is a simpler approach that removes the operational burden of duplicate reporting systems for ADIs with exposures subject to RBNZ capital requirements.

APRA has not proposed to implement this treatment more broadly, given the lesser materiality of exposures in other jurisdictions and that this could potentially result in an unwarranted reduction in group capital requirements.

6.3 SME exposures

APRA proposed merging the SME retail and SME corporate asset classes into a single SME asset class, with the regulatory capital function to be based on the current corporate risk-weight function. Loans to SMEs that are secured by residential property would also be included within this asset class.

Comments received

Most respondents did not support APRA's proposal, noting that this would significantly increase capital requirements for SME exposures and adversely affect the cost and availability of credit. Respondents recommended that APRA retain the current distinction between SME retail and SME corporate. One respondent supported the proposal to merge the asset classes, subject to overall capital requirements for the SME portfolio not increasing and recalibration of the lower end of the corporate correlation curve to allow for lower correlations for very small businesses.

APRA's response

APRA is no longer proposing to merge the two SME asset classes and will instead maintain the current treatment. SME retail secured by residential property will also not be subject to the RWA scalars that apply to either owner-occupied, principal-and-interest residential mortgages or other residential mortgages.

APRA is also proposing to increase the eligibility threshold for the SME retail treatment from $1m to $1.5m in aggregate exposure, in line with updates to the foreign currency thresholds in other parts of the standard. Other eligibility criteria relating to both the borrower and the exposure being non-complex, and that exposures are originated and managed in a similar manner to other retail exposures, will also need to be satisfied.

The eligibility for SME corporate exposures has also been increased from $50m in annual revenue to $75m. In relation to the firm-size adjustment for SME corporate exposures, APRA is proposing to remove the use of total assets as a measure where consolidated annual sales are not known. APRA has observed that most ADIs revert to the use of APRA-prescribed

default values where firm-size data is missing or invalid. These default values have been updated and incorporated into the standard.

6.4 Income-producing real estate exposures

For IPRE exposures, APRA proposed replacing the current supervisory slotting approach with an IRB risk-weight function based on two new sub-asset classes:

- land acquisition, development and construction exposures; and
- other IPRE exposures.

APRA signalled its intention to apply a multiplier to the RWA outcome calculated under the revised risk-weight functions to ensure the level of capital for IPRE exposures remained appropriate.

Comments received

Respondents supported the proposal to use an IRB risk-weight function for IPRE exposures, as this is likely to enhance risk sensitivity. In relation to the proposed risk-weight functions, respondents highlighted that the proposed asset correlations were materially higher than those under the Basel III framework for 'High Volatility Commercial Real Estate'. Some respondents also suggested that the proposed risk-weight functions and further application of an RWA multiplier would amplify increases in capital requirements in a downturn scenario.

Respondents also recommended that APRA retain the current treatment of exposures to large, well-diversified commercial property borrowers as general corporate exposures rather than moving these exposures to the new IPRE asset classes. It was suggested that these entities represent borrowers with significant portfolio diversification benefits which reduces their inherent default risk.

APRA's response

APRA is now proposing to implement a simpler and more transparent approach to IPRE exposures. Both AIRB and foundation IRB (FIRB) ADIs will be permitted to use the corporate risk-weight function, with an RWA multiplier applied to ensure that capital outcomes remain appropriate. For this purpose, APRA is proposing to apply a single RWA multiplier of 1.5, rather than segmenting IPRE exposures into two sub-asset classes. APRA considers that an adjustment to corporate RWA outcomes remains appropriate for IPRE exposures, as this portfolio has historically been a source of significant risk for Australian ADIs. APRA will retain supervisory slotting for IPRE exposures for those ADIs with inadequate property models. All other specialised lending asset classes will also continue to be subject to the supervisory slotting approach.

APRA is proposing to define IPRE consistent with current expectations and practice, although the definition will not align to that of commercial property under the standardised approach. The IPRE sub-asset class will include exposures that depend on the cash flows of the asset that is directly being financed, as well as exposures that depend on the cash flows of other assets owned by the borrower or on the performance of the property market more broadly. The definition also focuses on those exposures where the prospects for repayment, rather

than prospects for recovery, depend on the cash flows of the underlying property assets. APRA is also proposing to retain its current approach that allows for IPRE lending to certain large and well-diversified commercial property borrowers to be treated as corporate exposures where specified criteria are met. APRA intends to provide additional guidance on the definition of IPRE exposures in the revised Prudential Practice Guide APG 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk.

6.5 Qualifying revolving retail exposures

APRA proposed removing the qualifying revolving retail (QRR) asset class and including these exposures as part of the 'other retail' asset class instead.

Comments received

Respondents did not support APRA's proposal, noting that it represented a departure from the Basel III framework. Respondents highlighted that the proposals would result in a significant increase in capital that is not reflective of the risk of the portfolio, and may affect the availability of competitively priced credit card offerings. One respondent suggested retaining the separate asset classes but adjusting the correlation for QRR to increase risk weights by a lower amount than moving to the 'other retail' asset class.

APRA's response

APRA is now proposing to retain the QRR asset class in line with the Basel III framework. Consistent with Basel III, APRA is proposing to introduce a higher PD floor of 0.1 per cent for QRR exposures that have not been repaid in full for the past twelve months.

6.6 Loss given default

The Basel III framework does not permit banks to use modelled LGD estimates for financial institution and large corporate (revenues greater than AUD$750m) exposures. APRA proposed to extend modelling constraints to a wider range of LGD estimates. Specifically, APRA proposed to constrain LGD modelling for all unsecured non-retail exposures, with ADIs required to use supervisory estimates for these exposures instead. For this purpose, APRA proposed implementing multiple LGD categories based on a range of conditions, rather than implementing the Basel III FIRB estimates of 40 per cent for corporates and 45 per cent for financial institutions.

APRA also proposed applying higher LGD estimates under the FIRB approach for secured exposures. For the purpose of determining whether an exposure is secured under the FIRB approach, APRA signalled its intention to retain the current categories of eligible collateral, which includes eligible financial collateral, receivables and residential or commercial real estate.

Comments received

Respondents did not support the proposal to apply supervisory LGD estimates to all unsecured non-retail exposures as they considered that there was sufficient data available to inform LGD models for these exposures. Internally modelled unsecured LGDs allow for more sophisticated risk management and capital allocation decisions, while the use of supervisory

estimates lacks granularity and fails to fully recognise risk-sensitive decision making. Respondents were concerned that this proposal would place Australian IRB ADIs at a competitive disadvantage to international peers who are not similarly constrained.

Respondents did not support APRA's proposal to segment unsecured non-retail exposures into different LGD buckets (45 per cent and 60 per cent), and expressed concerns in relation to the complexity of the proposed approach. In particular, respondents highlighted that it would be difficult to consistently define and apply the requirements that the assets of the borrower are readily realisable and the borrower holds low levels of debt, noting that these will often vary across specific sectors.

For the purpose of secured exposures, respondents also recommended that APRA recognise 'other physical collateral' in line with the Basel III framework. Recognition would maintain risk sensitivity, international comparability and competitiveness, and provide appropriate incentives to obtain collateral.

APRA's response

In addition to considering respondents' written submissions, APRA also undertook further detailed consultation with IRB ADIs on the LGD proposals. In response, APRA is proposing certain amendments to its 2018 proposals.

- Constraints: APRA is proposing to proceed with constraining LGD modelling for all unsecured non-retail exposures, and requiring ADIs to use supervisory estimates. Rather than multiple supervisory LGDs, APRA is proposing a single estimate of 50 per cent for senior unsecured exposures. While APRA considered having a range of unsecured LGD estimates, ultimately this was deemed too complex to implement consistently. APRA considers that a higher LGD estimate than under Basel III remains appropriate for these exposures.

- Definition of unsecured: AIRB ADIs will be permitted to use their own definition for determining whether an exposure is unsecured. For FIRB ADIs, unsecured exposures refer to those exposures not secured by eligible collateral. APRA is proposing to expand the definition of eligible collateral so that other physical collateral may be recognised for this purpose. APRA is also exercising the national discretion to allow IPRE to be recognised as eligible collateral under the FIRB approach where it meets certain conditions.

- Subordinated exposures: All subordinated exposures will be subject to a 75 per cent supervisory LGD estimate. ADIs will be required to set their own definition of subordination, which must address not only contractual, but also economic, subordination.

- Sovereign exposures: APRA is proposing that all sovereign exposures will be subject to the FIRB approach, with supervisory LGD estimates in line with the LGD estimates currently applied by most IRB ADIs. This includes a 5 per cent LGD for sovereigns rated AA- or better and 50 per cent LGD for all other sovereigns.

- FIRB: most other FIRB estimates (excluding other physical collateral) are now aligned with the revised Basel III estimates; the values for secured exposures have been reduced

and collateral haircuts recalibrated. APRA has also adopted the LGD floors consistent with the Basel III framework, including for partially secured exposures.

APRA's current LGD proposals are summarised in Table 7 and Table 8 below.

Table 7. LGD proposals – unsecured exposures

	LGD supervisory estimates (%)	LGD floors under the AIRB approach (%)
Sovereign		
AA- or better	5	n/a
Other	50	n/a
Senior unsecured	50	25
Subordinated	75	25

Table 8. LGD proposals – secured exposures

	LGD supervisory estimates (%)	Collateral haircut (%)	LGD floors under the AIRB approach (%)
Financial collateral	0	As per APS 112	0
Receivables	20	40	10
Residential or commercial real estate	20	40	10
Other physical collateral	30	40	15

6.7 Exposure at default

The Basel III framework does not permit banks to use modelled EAD estimates for financial institution and large corporate exposures, non-revolving commitments and revolving commitments that are subject to a 100 per cent CCF under the standardised approach. APRA proposed to extend this modelling constraint to all non-retail revolving commitments. As outlined above in section 5.12.2, APRA also proposed applying certain CCF estimates that are higher than those under Basel III.

Comments received

One respondent suggested that AIRB ADIs should be permitted to continue to use modelled EAD estimates for small- and mid-sized corporates, as there was sufficient data to inform EAD models for these types of exposures.

While a number of respondents supported the proposal to align CCFs between the standardised, FIRB and AIRB approaches, most requested that the estimates be aligned with those set out under the Basel III framework.

APRA's response

APRA is proposing to proceed with constraining EAD for all non-retail commitments and requiring ADIs to use supervisory estimates. Modelling of EAD estimates for non-retail portfolios has been challenging for ADIs. Even for those segments where there is more default data, substantial changes to a customer's product mix in the lead-up to default affect ADIs' ability to determine appropriate EAD estimates. APRA therefore considers that supervisory estimates are more appropriate for all non-retail EAD. While APRA had initially proposed to apply supervisory estimates ranging from 50 to 100 per cent to 'other commitments' based on counterparty type, APRA is now proposing to align with the Basel III framework and apply a single supervisory estimate of 40 per cent to those commitments. Commitments such as direct credit substitutes and performance guarantees will be subject to the standardised CCFs that have been aligned with the Basel III framework.

For non-revolving retail exposures, APRA proposes to proceed with a supervisory CCF estimate of 100 per cent. Given the way non-revolving retail products are managed by ADIs, there is insufficient evidence to support an estimate below 100 per cent. APRA acknowledges that this CCF is higher than that proposed under the standardised approach; however, APRA considers the standardised CCF to be an explicit concession as standardised ADIs are unable to recognise the benefits of, for example, prepayments in the same way as IRB ADIs.

Consistent with the Basel III framework, revolving retail exposures will be subject to an EAD floor. The floor is the sum of the on-balance sheet exposures and 50 per cent of the off-balance sheet exposure using the applicable CCF under the standardised approach.

APRA's EAD proposals are summarised in Table 9 below.

Table 9. EAD proposals

<table>
<tr><th></th><th>Internally modelled</th><th>Standardised (%)</th><th>IRB (%)</th></tr>
<tr><td>Revolving retail</td><td>Yes</td><td rowspan="3">40</td><td>N/A</td></tr>
<tr><td>Non-revolving retail</td><td>No</td><td>100</td></tr>
<tr><td>Non-retail</td><td>No</td><td>40</td></tr>
</table>

6.8 Other APS 113 changes

In addition to those changes identified above, APRA is also proposing a number of other amendments to APS 113. These amendments reflect both changes in response to the Basel III framework and APRA's observations of risk and practice.

The draft APS 113 accompanying this response paper has been revised significantly. The structure of the standard has been amended to better align with the Basel Committee's

consolidated framework, and allow for an easier comparison between APRA's framework and the Basel III framework. Further, given the requirement to apply the standardised approach to a number of asset classes (e.g. non-standard residential mortgages, margin loans, equities), these exposures have been carved out of the scope of APS 113, and the references to a 'residual IRB' asset class removed.

Table 10. Summary of other changes to APS 113

Reference	Requirement	Summary
[18]	Modelling constraints	Consistent with Basel III, the FIRB approach applies to all financial institution and large corporate exposures. APRA is also extending the FIRB approach to sovereign exposures.
[23]	Governance and control processes	An ADI must have documented policies that detail sound rating system development, validation, implementation, governance and control processes.
[26]	Accountability	An ADI's policies must identify the personnel responsible for the performance of its rating systems and establish performance standards in relation to those responsibilities.
[52]	Phased roll-out	During the phased roll-out period, APRA may withhold a significant portion of any expected regulatory capital benefit from initial IRB approval.
[54]	Model change approvals	An ADI must seek prior approval (rather than prior notification) from APRA for material changes to ratings systems or modelling assumptions.
[20] Att A	Lease exposures	Consistent with the treatment under the standardised approach, APRA is proposing to implement a higher risk weight of 250 per cent for the portion of aggregate residual value greater than 10 per cent of Tier 1 capital.
[22]-[24] Att A	Defaulted exposures	Consistent with its application of multipliers on certain asset classes, APRA is proposing to apply the same multipliers to defaulted residential mortgage and IPRE exposures.
[3] Att B	PD floors	Consistent with Basel III, the PD floor has increased from 0.03 per cent to 0.05 per cent for all exposures, with the exception of sovereign exposures (no PD floor) and QRR revolvers (0.1 per cent PD floor).
[15]-[22] Att B	LGD floors	Consistent with Basel III, LGD floors for AIRB and retail exposures have been introduced.
[26] Att B	Purchased defaulted assets	For the capital treatment of purchased defaulted assets under the FIRB approach, APRA is proposing that the EAD estimate must be set equal to the purchase price and the discount must be set equal to zero. As a result, where an ADI purchases a defaulted

Reference	Requirement	Summary
		asset at a discount to face value, it will no longer be able to use the discount to offset shortfalls in provisions for other defaulted exposures.
[76]-[77] Att D	PD estimation	Consistent with Basel III, PD estimates are to be based on count weighted default rates, and default data must include a representative mix of good and bad years of the economic cycle.
[82] Att D	LGD estimation	LGD estimates must take into account additional drawings after default, and these additional drawings must no longer be reflected in EAD estimates.
[97]-[100] Att D	EAD estimation	Consistent with Basel III, ADIs must apply certain new requirements for EAD estimation.
[104], [109] Att D	Validation of internal estimates	Validation must be undertaken at least annually and by personnel independent from those responsible for model development. ADIs must validate the zero per cent CCF for exposures exempt from the definition of commitment.
[18] Att E	Guarantees	Consistent with Basel III, the recognition of conditional guarantees under the AIRB and retail IRB approaches have largely been removed, except those guarantees that cover losses remaining after the institution has first pursued the original borrower for payment and has completed the workout process.
Other	Currency conversion thresholds	In line with the proposed approach under APS 112, APRA is proposing to adjust the currency conversion thresholds in APS 113. Basel III includes thresholds that are denominated in both Euros and US dollars. APRA is proposing to convert Euro thresholds at the rate of 1.5 and US dollar thresholds at the rate of 1.25.
	Credit risk mitigation	In line with Basel III, the double default approach has been removed. The recognition of conditional guarantees and certain types of derivatives as eligible CRM has also been restricted.
	Back-out approach	The use of the back-out approach for retail PD and LGD estimation has been removed. The use of the back-out top-down approach for purchased corporate receivables has also been removed.

Chapter 7 - Consultation and next steps

7.1 Request for submissions and cost-benefit analysis information

APRA invites written submissions on the proposals set out in this response paper and the accompanying draft prudential standards. Written submissions should be sent to ADIpolicy@apra.gov.au by 1 April 2021 and addressed to:

General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

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.

APRA asks that all stakeholders use this consultation opportunity to provide information on the compliance impact of the proposals, and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any changes to compliance costs incurred by businesses as a result of APRA's proposals.

Consistent with the Government's approach, APRA will use the methodology behind the Commonwealth Regulatory Burden Measure to assess compliance costs. This 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/.

APRA requests that respondents use this methodology to estimate costs to ensure the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their costs assessment to APRA, respondents should include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake due to foreign regulatory requirements or in their ordinary course of business.

APRA