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APRA

21 July 2021

TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

BANK CAPITAL REFORMS: UPDATE

APRA recently published a roadmap for finalising reforms to the bank capital framework, which are due to come into effect from January 2023.[1] This letter provides an early indication on key policy settings for the framework, to help the industry plan ahead for implementation.

Update on policy settings

The aim of the bank capital reforms is to strengthen the financial resilience of the industry; the new framework will embed the industry's unquestionably strong level of capital, with higher capital buffers providing greater flexibility for periods of stress.

In December 2020, APRA released a consultation package on the draft prudential standards that will underpin these reforms.[2] Responses from industry and other stakeholders were submitted in April 2021. Following review of these submissions, APRA is providing an update on key policy settings to assist the industry with capital planning.

In summary, APRA intends to:

- maintain the approach to capital buffers outlined in the consultation package, including a base level for the counter-cyclical capital buffer (CCyB) of 1.0 per cent of risk-weighted assets (RWAs);

- modify the proposed capital requirements for higher risk residential mortgage lending, with changes to the definition of long-term interest only loans; and

- revise certain settings to calibrate the new framework to meet the unquestionably strong benchmarks, and simplify requirements where possible.

These intended policy settings are outlined in detail in the annexes below, which also include responses to a range of other technical issues raised by ADIs in the consultation. This update covers the key issues that are most material to the revised capital framework. Importantly, the full suite of policy settings is not yet final, and there may be further revisions to these and other issues as APRA finalises the prudential standards later this year.

Next steps

While this letter does not represent a formal consultation, ADIs are welcome to provide further feedback on these proposed policy settings by 20 August 2021. In addition, to understand the impact of these revisions, APRA will conduct a further quantitative impact study (QIS). The QIS will be optional for ADIs and conducted on a best-efforts basis, with responses also due

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[1] See https://www.apra.gov.au/adi-capital-reforms-roadmap-to-2023

[2] See https://www.apra.gov.au/news-and-publications/apra-seeks-to-enhance-flexibility-and-resilience-of-adi-capital-framework

by 20 August 2021. Consistent with the roadmap, APRA is aiming to release final prudential standards in November 2021, which will come into effect from 1 January 2023.

If you have any questions on the QIS or feedback on the revised settings, please direct these to ADIPolicy@apra.gov.au and copy in your supervision team. APRA will also continue to engage with ADIs on the QIS and reforms more broadly, through the scheduled workshops coordinated by relevant industry associations.

Yours sincerely,

Gideon Holland
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ANNEX A. OVERARCHING REQUIREMENTS THAT ARE UNLIKELY TO CHANGE

This section outlines the key overarching capital requirements that are unlikely to change from the proposals in APRA's December 2020 consultation package. APRA may provide further guidance on these issues in the final response package and updated prudential practice guides (PPGs).

Capital buffers

In December 2020, APRA consulted on a number of proposals to update *Prudential Standard APS 110 Capital Adequacy* to improve the flexibility of the framework and meet the unquestionably strong benchmarks. This included increased capital buffers above minimum prudential requirements, to support the ability of ADIs to absorb losses and continue lending during times of stress.

Specifically, APRA proposed to:

- set a base level for the countercyclical capital buffer (CCyB) of 1.0 per cent of RWA for all ADIs; and
- increase the capital conservation buffer (CCB) from 2.5 to 4.0 per cent of RWA for IRB ADIs. The CCB for ADIs on the standardised approach would remain at 2.5 per cent.

In industry feedback, some IRB ADIs requested that APRA set a higher base level for the CCyB, with a commensurate decrease in the CCB, to promote additional flexibility in times of stress. IRB ADIs also highlighted that internal models are more exposed to procyclicality in capital requirements.

APRA has carefully considered the level and composition of buffers in the capital framework. APRA intends, however, to maintain the approach to buffers as set out above, consistent with the proposals in December 2020. Further increases to buffers for ADIs using the standardised approach would impact other objectives for the reforms, and APRA does not believe it is appropriate to set a different base level for the CCyB for IRB ADIs.

Residential mortgages

A key objective in the reforms is to strengthen capital requirements for residential mortgage lending, to reflect risks posed by Australian ADIs' structural concentration in this asset class. To this end, APRA proposed a number of changes to capital requirements for higher risk mortgage lending, increasing the capital allocated to housing relative to other loans.

In line with this, APRA intends to maintain the following specific proposals, as set out in the December 2020 consultation:

- lower risk residential mortgages to be defined as lending to *owner-occupiers on a principal-and-interest basis*, with other residential mortgages categorised as higher risk;
- prescribed risk weights under the standardised approach and RWA multipliers under the IRB approach to remain at the levels specified in the December 2020 consultation;
- lenders' mortgage insurance (LMI) to be recognised as a 20 per cent benefit, reducing capital requirements under both standardised and IRB approaches;
- credit conversion factors (CCFs) to be applied to undrawn exposures, and the removal of the unconditionally cancellable category; and

- the mortgage risk-weight floor for the IRB approach to be set at 5 per cent, limiting the difference in capital between the standardised and IRB approaches.

APRA plans, however, to refine capital requirements for higher risk mortgage lending through changes to the definition of long-term interest-only loans. The changes to the definition are set out in detail in Annex B below.

Competition impacts

The proposed reforms to the capital framework will, in APRA's view, enhance competition in the industry. The reforms include higher capital buffer requirements for larger banks that use the IRB approach, and a new floor on IRB risk weights which will limit the benefits of internal models relative to smaller banks on the standardised approach. The net effect of these and other changes will be to materially narrow the gap in capital requirements between the IRB and standardised approaches.

A number of submissions from industry suggested that APRA should consider reducing capital requirements for lower risk residential mortgages on the standardised approach, to further enhance competition. To reduce risk weights for mortgages at low loan-to-valuation ratios (LVRs) would, however, push them below minimum international standards set by the Basel Committee on Banking Supervision. APRA does not, therefore, plan to reduce mortgage risk weights below these minimum international standards. The gap in capital requirements that does remain between the IRB and Standardised approaches reflects, in APRA's view, the better risk sensitivity of advanced modelling.

SME retail

In December 2020, APRA proposed setting the eligibility level for loans to be classified as 'SME retail' at a maximum of $1.5 million in aggregate exposure. Some ADIs noted that the ABA banking code of practice defines SME retail using a higher maximum level of $3 million in total debt. APRA is, however, likely to maintain the proposed $1.5 million cap, as the higher level would not meet Basel standards. For SME exposures above $1.5 million, ADIs may still opt to use retail-like models but must classify these loans as 'SME corporate'.

ANNEX B. APS 112 REVISED POLICY SETTINGS

This section outlines potential revisions to the draft *APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)*, building on APRA's December 2020 consultation package. ADIs that complete the QIS should use the indicative proposals in this section. Unless otherwise stated, all other policy settings should be assumed to be in line with the December 2020 consultation.

Residential mortgages – interest-only lending

APRA's December 2020 proposal categorised residential mortgages with an interest-only period of greater than five years 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. Additionally, these borrowers may face significant 'repayment shocks' when their interest-only periods end and they are required to make repayments on a principal and interest basis.

As a result, APRA considered that a non-standard categorisation would better represent the risks associated with long-term interest-only mortgages, and a higher risk weight of 100 per cent to be appropriate. APRA still considers it appropriate to treat mortgages with an interest-only period of greater than five years as 'non-standard' loans. However, after considering industry feedback, APRA intends to narrow the scope of the non-standard definition.

APRA proposes two key changes:

- the five-year interest-only period would be based on contractual length, rather than an aggregation that includes prior periods. APRA acknowledges there is less risk if ADIs have undertaken a serviceability assessment as part of refinancing or renewal activity; and
- exposures with a loan-to-value ratio (LVR) less than or equal to 80 per cent would be excluded. These borrowers are less vulnerable to falling into negative equity.

This revised approach is set out in the following paragraph, which is intended to be included in Attachment A of APS 112 (paragraph 19): *The following exposures must also be classified as non-standard loans: (a) Interest only loans with an LVR greater than 80 per cent and an interest-only term that is of unspecified duration or is specified in the loan contract as greater than five years. The non-standard treatment applies while the loan remains on interest-only repayment terms. Exposures that meet the above criteria but are predominantly for business purposes may be excluded.*

Residential mortgages – interest-only seasoning

In December 2020, APRA proposed to treat all interest-only mortgages as 'other residential mortgages' in the six months following conversion to principal-and-interest repayments. These loans are subject to higher risk during this period, with borrowers more likely to fall into arrears or default. However, APRA no longer intends to pursue this proposed seasoning requirement (in draft APS 112 Attachment A paragraphs 14(b) and 21) in order to simplify implementation and improve alignment with the treatment of other loans under the capital framework.

Mixed property collateral

APRA originally proposed that where a loan is secured by both residential and commercial property, and the predominant security is residential property, the ADI must: (i) treat the loan as a residential property exposure and (ii) only include the aggregated value of residential properties in the LVR calculation.

Submissions commented that the lack of recognition of commercial property collateral in such exposures would present commercial challenges for business lending. It was suggested that the value of commercial property be included in the LVR calculation.

In response to these concerns, APRA intends to allow ADIs to use commercial property in the LVR calculation for mixed collateral exposures, subject to a 40 per cent haircut on the value of the collateral. This approach recognises the value of the commercial property, but with a haircut to reflect the greater risk of this collateral compared to residential property. This LVR would then be used to determine the risk weight for exposures where the predominant security is residential property.

APRA plans to update APS 112 Attachment A (paragraph 11(b)) to: *where a loan is secured by multiple properties, an ADI must use the aggregate value of the mortgaged properties for the purpose of calculating LVR. Where a residential property exposure is secured by both residential and commercial properties, an ADI must apply a 40 per cent haircut to the value of any commercial property included in the calculation of LVR;*

SME definition

In December 2020, SME lending was defined in the draft APS 112 Attachment B (paragraph 22) as *an exposure to a corporate counterparty with total consolidated annual revenue of less than or equal to $75 million*. In response to industry feedback, APRA intends to also allow ADIs to include a corporate exposure as SME where its consolidated annual revenue cannot be determined but exposure size is less than $5 million. Further, to simplify the SME definition and achieve greater consistency between the IRB and Standardised approaches, APRA is planning to revise the SME revenue threshold to 'less than $75 million' across both approaches.

Margin lending

In response to industry feedback, APRA intends to adjust its draft definition of off-balance sheet commitments to clarify the approach for margin lending. This will align with the existing definition of a 'credit limit' used in the reporting standards.

The following additional paragraph would be included in Attachment C to APS 112: *In respect of margin lending, the committed amount is the maximum amount that the borrower can draw down based on the terms of the loan (such as the notional credit limit and the maximum allowable LVR) and the value of the security underlying the loan. However, if an ADI does not adjust the credit limit before a drawdown in response to a decline in security value, then the ADI must use the original amount in the loan contract that is independent of the security value.*

Subordinated debt

The draft APS 112 adopts a new definition of subordinated debt, with a risk weight of 150 per cent for holdings of subordinated debt issued by commercial (non-financial) entities. To recognise the inherent risk associated with these exposures, APRA intends to also include economic subordination within the definition of subordinated debt.[3] APRA plans to provide further guidance on the definition of economic subordination in the revised APG 112 and APG 113.

APRA intends to update APS 112 Attachment B (paragraph 33) with the following: *Subordinated debt includes any facility that is expressly subordinated to another facility, or*

[3] Economic subordination could potentially arise when lending to a holding company with revenue generating operating subsidiaries, or when the ADI's facility is ranked behind other creditors.

has the effect of conveying economic subordination to another facility. Subordinated debt that is not required to be deducted from regulatory capital under APS 111 must be risk weighted at 150 per cent.

Off-balance sheet exposures

There were a number of issues raised in submissions regarding the definition of a commitment and CCFs. APRA plans to provide the following clarifications:

- Conditions precedent: Some industry respondents suggested the proposed definition of a commitment would capture arrangements involving conditions precedent and questioned whether this was intended. APRA considers that it would still be prudent to treat exposures with conditions precedent as commitments, given these may involve circumstances outside the control of the lender and result in a credit exposure arising at any point in time. APRA is clarifying this in APS 112 Attachment C (paragraph 2):

  A commitment includes any arrangement that can be unconditionally cancelled by the ADI at any time without prior notice to the borrower. It also includes any such arrangement that can be cancelled by the ADI if conditions set out in the facility documentation are not met, including conditions that must be met by the borrower or third parties (conditions precedent) prior to any initial or subsequent drawdown under the arrangement.

- Master agreements: Some industry respondents noted that the proposed definition would limit ADIs' ability to provide certainty relating to future finance availability to their customers. APRA is not intending to adjust the definition of commitment for this purpose and believes the scope of exclusions provided in APS 112 Attachment C (paragraph 3) to be sufficient. However, APRA intends to clarify in the PPG that: *An arrangement that does not advise a lending limit, and only stipulates the terms and conditions of future trades and limit establishment, does not generally constitute a commitment.*

- Mortgage CCFs: For ADIs applying the standardised approach, APRA is planning to include additional examples in APG 112 to clarify the CCFs to be applied to residential mortgages. In the case of a loan that has been approved but not yet advanced, APRA would expect the 100 per cent CCF for commitments with certain drawdown to be applied. In the case of a mortgage loan that allows redraw and has been paid down by the borrower ahead of schedule, or an equity line of credit facility, APRA would expect the 40 per cent CCF for other commitments to be applied to the off-balance sheet portion.

ANNEX C. APS 113 REVISED POLICY SETTINGS

This section outlines potential revisions to the draft *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk (APS 113)*, building on APRA's December 2020 consultation package. ADIs that complete the QIS should use the indicative proposals in this section. Unless otherwise stated, all other policy settings should be assumed to be in line with the December 2020 consultation.

IRB RWA scalar

In December 2020, APRA proposed an IRB scaling factor of 1.1 to calibrate outcomes consistent with the unquestionably strong capital benchmarks. This scaling factor would be applied to RWAs for all IRB asset classes under APS 113. APRA is proposing to revise the IRB scaling factor to 1.05 to calibrate unquestionably strong, and may revisit this further as a result of the QIS.

New Zealand exposures

In December 2020, APRA proposed that its IRB requirements would also apply to any exposures of overseas banking subsidiaries that form part of the Level 2 group, with the exception of exposures of New Zealand subsidiaries. For these exposures, ADIs would be required to use credit RWAs set by the Reserve Bank of New Zealand (RBNZ). This approach was intended to simplify capital calculations and remove operational burden.

Some submissions contended that the proposal was conservative and recommended removing the requirement to use RBNZ's overall IRB scalar and capital floor in Level 2 calculations. APRA's current intention is to continue with its proposal to require ADIs to use credit RWAs set by the RBNZ. Further consideration, however, is being given to the merits of the proposal to apply RBNZ's overall IRB scalar and capital floor. APRA will review the results from the QIS at Level 1 and 2 consolidations to determine a final approach.

Defaulted exposures

In December 2020, APRA proposed that RWA scalars for residential mortgages and IPRE would apply to both defaulted and non-defaulted exposures. Some industry submissions contended that IRB RWAs for defaulted assets already have in-built conservatism and these scalars would not reflect the actual risk of further loss, and may potentially increase procyclicality during stress. To this end, APRA intends to remove these asset class scalars for defaulted exposures. The overall IRB RWA scalar will still apply to all exposures, including defaulted exposures.

SME definition

APRA originally proposed that ADIs must use consolidated annual revenue to determine whether a borrower would fall under the SME threshold of $75 million. Respondents noted difficulties in procuring audited financial statements from some SMEs for the purposes of determining their consolidated annual revenue. APRA is intending to remove the requirement for ADIs to use audited financial statements for this purpose, although this requirement will remain for the determination of large corporate exposures and financial institutions.

Sovereign LGD

In December 2020, APRA proposed that all sovereign exposures would be subject to the FIRB approach. Specifically, ADIs using the IRB approach would apply a 5 per cent loss given default (LGD) for exposures to sovereigns rated AA- or better, and a 50 per cent LGD to all

other sovereigns. In response to the feedback provided around potential cliff effects, APRA intends to introduce an additional LGD category for A+ and A rated exposures, with a prescribed LGD of 25 per cent. This more graduated approach is set out in the table below.

	AAA/AA	A+ and A	A- and below
LGD (%)	5	25	50

Other physical collateral

In December 2020, APRA proposed a definition for a category of exposures to be treated as '*Other eligible physical collateral*' under foundation IRB (FIRB). To be eligible for this category, the criteria included that there are liquid markets and publicly available market prices for the physical collateral. ADIs suggested the criteria be broadened, to allow more exposures to be treated in this category.

APRA is proposing to maintain the proposed criteria for this category rather than broaden it, consistent with the Basel standards. However, APRA recognises that under the FIRB approach there is some physical collateral with recovery value that should also be recognised.

APRA is therefore intending to add a new category entitled '*Exposures with eligible recovery value*'. This category will have specific supervisory LGD and collateral haircuts (H_c), as outlined in the table below. APRA also intends to revise the supervisory LGD for 'Other eligible physical collateral' to 25 per cent, to align with the Basel standards.

Category	LGD (%)	H_C (%)
Other eligible physical collateral	25	40
Exposures with eligible recovery value	Exposure to FI: 45 Exposure to corporate: 40	40

The new '*Exposures with eligible recovery value*' category would include exposures secured by physical collateral that do not meet the criteria in the draft standard (APS 113 Attachment E, paragraph 7). It would also include Australian water entitlements, and senior exposures to operators of large public infrastructure or utilities that provide essential service to the economy.[4]

Public sector entities

In December 2020, APRA did not specify how domestic public sector entities (PSEs) should be treated in APS 113. To clarify, IRB ADIs would include domestic PSEs in the definition of financial institution (FI) under APS 113. ADIs would also apply an asset value correlation multiplier set to one in calculating RWAs arising from exposures to domestic PSEs.

[4] An essential service, in this context, includes a service which has a tripartite agreement with the Commonwealth or is valued based on the regulatory asset base (RAB).