APRA

RESPONSE TO SUBMISSIONS

Finalising the Bank Capital Reforms

November 2021

Disclaimer Text

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Executive summary

In July 2017, APRA announced its intention to review the long-standing requirements in the ADI capital framework. Since this time, APRA has undertaken several rounds of consultations on its proposals and, in December 2020, consulted on draft prudential standards on credit risk and capital adequacy. It has also conducted a number of quantitative impact studies to aid in calibrating the new framework.

APRA's review over the past four years has aimed to achieve two key objectives: providing the regulatory foundations for maintaining an unquestionably strong level of capital in the industry, and meeting internationally agreed Basel III standards. APRA has also sought to achieve a number of key improvements to the framework: to enhance flexibility, risk sensitivity, competition, transparency and proportionality.

This *Response to submissions* paper sets out APRA's response to feedback received in December 2020 consultation. It covers a range of capital management and technical issues, and should be read in conjunction with the information paper *An Unquestionably Strong Framework for Bank Capital*.

Consultation process

In the latest round of consultation, APRA received 20 submissions, and undertook more detailed engagement with a number of ADIs through workshops and bilateral discussions. In July 2021, APRA provided an update on the direction of key policy settings and conducted a further quantitative impact study to assess the impact of the near-final proposals.

The key changes following consultation over the past year are:

- **Capital management (APS 110):** The calibration of the capital framework has been refined to ensure it meets the unquestionably strong benchmarks at an industry level, including an adjustment to the capital conservation buffer for IRB ADIs;

- **Residential mortgages (APS 112):** Capital requirements for higher risk residential mortgage lending have been modified, with changes to the definition of long-term interest only loans that would be treated as non-standard; and

- **Technical requirements (APS 113):** A range of other definitions, classifications and technical requirements have been adjusted for ADIs that use the internal-ratings based approach to capital (IRB), including scalars for exposures of New Zealand subsidiaries.

Table 1 below summarises the key changes made to the standards. The following chapters explain the feedback received during consultation and APRA's response in more detail.

Alongside this response paper, APRA has released final versions of *Prudential Standard APS 110 Capital Adequacy* (APS 110), *Prudential Standard APS 112 Standardised Approach to Credit Risk* (APS 112) and *Prudential* Standard *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113). These revised standards come into effect from 1 January 2023.

Next steps

APRA is now moving into the implementation phase of the reforms to the ADI capital framework. This will involve:

- **Finalising guidance:** Draft prudential practice guides, to assist ADIs in complying with APS 110, APS 112 and APS 113, have been released for consultation alongside this response paper, and will be finalised in 2022;
- **Reporting:** APRA will commence consultation in 2022 on the accompanying reporting standards for capital, which will be implemented over a longer timeframe (2023-2024); and
- **Related standards:** APRA will be reviewing related prudential standards over the course of 2022, including those related to market risk capital and public disclosure. These are outlined in Table 2 below.

APRA invites written submissions on the draft prudential practice guides APG 110, APG 112 and APG 113. Written submissions should be submitted to APRA by **11 March 2022**. Further detail on the implementation timeline is outlined in APRA's industry letter *ADI capital reforms: Roadmap to 2023*.[1]

Table 1. Key revisions to the capital standards over the past year

	December 2020 consultation	Final standards
APS 110		
Capital buffers	CCB set at 2.5% Additional CCB of 1.5% for IRB ADIs D-SIB buffer at 1.0% CCyB set at 1.0% baseline	No change to buffers, other than to reduce the additional CCB for IRB ADIs from 1.5% to 1.25%
Capital floor	IRB RWA must be at least 72.5% of RWA calculated under the standardised approach	Maintained original position
Simplified capital framework	Eligible ADIs to benefit from simpler capital requirements	Maintained original position
APS 112		
Residential mortgages	Standard residential mortgages segmented into 'owner-occupied, P&I' and 'other loans' Mortgages with an interest-only period greater than five years categorised as 'non-standard' loans	Maintained approach to segmentation Only mortgages with a contractual interest-only period greater than five years and an LVR greater than 80% are considered 'non-standard'

[1] APRA's letter: *ADI capital reforms: Roadmap to 2023* (2 June 2021) https://www.apra.gov.au/adi-capital-reforms-roadmap-to-2023

	December 2020 consultation	Final standards
Commercial property	Commercial property collateral not recognised in the LVR for residential mortgage loans with mixed collateral	Commercial property recognised in LVR for loans with mixed collateral, subject to a 40% haircut
SME exposures	Risk weighted based on value of security. Unsecured exposures risk weighted at 75-85% depending on size	Maintained original position
Off-balance sheet commitments	A 40% credit conversion factor (CCF) for residential mortgages	Maintained original position, clarifying that where a loan has been approved but not yet advanced, a 100% CCF would apply
Subordinated debt	Definition based on facilities which are expressly subordinated to another facility	Alignment of the definition of subordinated debt with APS 113, to include economic subordination
APS 113		
IRB scaling factor	Factor of 1.1 to calibrate IRB outcomes	Maintained original position, subject to some carve outs
New Zealand exposures (Level 2 subsidiaries)	RWA determined by RBNZ used at Level 2, including RBNZ scalar and floor	Maintained original position, but replacing RBNZ scalar and floor with APRA equivalents
Sovereign LGD	Senior unsecured sovereign exposures subject to LGDs: • 5% for AA- or higher • 50% for all other	Senior unsecured sovereign exposures subject to LGDs: • 5% for AA- or higher • 25% for A+, A and unrated Australian local councils • 50% for other sovereigns (including unrated)
Other physical collateral	Eligibility criteria included liquid markets, publicly available prices and physical inspection for inventories. 30% FIRB LGD and 40% haircut	Criteria adjusted to support practical implementation. FIRB LGD adjusted to 25% and 40% haircut
SME retail	Requirement to use audited financial statements in applying SME threshold. Aggregation based on *Prudential Standard APS 221 Large Exposures* (APS 221)	Flexibility provided: no requirement for audited financial statements and aggregation is largely based on APS 221
Public sector entities (PSEs)	Treated as corporate exposures, but domestic PSEs treated as FI	All PSEs treated as corporate exposures

Table 2. Implementation: guidance and other capital standards[2]

Capital reforms	APRA code	Type	Consultation	Effective
Capital Adequacy	110	PPG and reporting	2022	2023
Standardised Approach to Credit Risk	112	PPG and reporting	2022	2023
Internal Ratings-based Approach to Credit Risk	113	PPG and reporting	2022	2023
Interest Rate Risk in the Banking Book	117	Standard, PPG and reporting	2022	2024
Public Disclosure	330	Standard	2022	2024
Market Risk	116	Standard and reporting	2022	2025
Counterparty Credit Risk	180	Standard and reporting	2022	2025

[2] The timelines for revisions to APS 117 and associated reporting, and other market risk standards, were updated in APRA's letter: *Review of ADI market risk standards* (27 October 2021) to provide additional time for implementation. https://www.apra.gov.au/review-of-adi-market-risk-standards. APRA intends to consult on the reporting standards for Market Risk and Counterparty Credit Risk in early 2023.

Glossary

ADI	Authorised deposit-taking institution
AIRB	Advanced IRB approach
APRA	Australian Prudential Regulation Authority
APG 110	*Prudential Practice Guide APG 110 Capital Adequacy*
APG 112	*Prudential Practice Guide APG 112 Capital Adequacy: Standardised Approach to Credit Risk*
APG 113	*Prudential Practice Guide APG 113 Capital Adequacy: Internal Ratings-based 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 117	*Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*
APS 180	*Prudential Standard APS 180 Capital Adequacy: Counterparty 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 *Basel III: Finalising post-crisis reforms* (December 2017), *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
D-SIB	Domestic systemically important bank, as determined by APRA
EAD	Exposure at default
FIRB	Foundation IRB approach
IPRE	Income-producing real estate

IRB ADI	An ADI which has been approved by APRA to use the internal ratings-based approach to credit risk
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
SME	Small- and medium-sized enterprise
Standardised ADI	An ADI that only uses the standardised approach to credit risk, to determine its capital adequacy requirements, as the ADI has not been approved by APRA to use the internal ratings-based approach to credit risk

Chapter 1 – Capital adequacy

This chapter outlines APRA's response to submissions on the proposed revisions to APS 110, following consultation in 2021. Having considered industry feedback, APRA has finalised APS 110 and released a marked-up version relative to the December 2020 draft.

1.1 Capital buffers

In December 2020, APRA consulted on a number of proposed changes to capital buffers. These proposals were designed to achieve a number of objectives, including to meet the 'unquestionably strong' benchmarks and improve the flexibility of the framework.

APRA's proposals included increased capital buffers above minimum prudential requirements, to support the ability of ADIs to absorb losses and continue lending during periods of stress. Specifically, APRA proposed to:

- set a baseline level for the countercyclical capital buffer (CCyB) of 1.0 per cent of RWA; 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.

APRA also signalled its intention to retain the minimum PCR at 4.5 per cent of RWA for Common Equity Tier 1 Capital (CET1) and the loss absorption trigger at 5.125 per cent of RWA. The rationale for this was to support a greater proportion of capital being held through buffers and, in turn, support the flexibility of the framework.

Comments received

APRA received a range of submissions on the proposed buffers. Submissions supported APRA's objectives, particularly the proposal to set a baseline level for the CCyB above zero. There was, however, a range of feedback on the design and operation of buffers.

To maximise flexibility in stress, some respondents recommended that APRA modify the size and types of buffers. For example, some ADIs suggested that APRA should consider a higher baseline level for the CCyB, with a commensurate decrease in the CCB. Alternatively, given potential market pressure to continue paying dividends and coupons, restrictions on capital distributions could be modified to only apply after the first 1.0 per cent top tranche of the CCB, or a new buffer could be designed that would not constrain distributions.

Some respondents also requested that APRA provide further guidance on how to set management targets in APG 110, and raised concerns on the usability of regulatory buffers. Some ADIs have contended that there may be reluctance to use buffers, given the potential stigma associated with operating within the range of the CCB.[3] In addition, some submissions

[3] The CCB range consists of the capital conservation buffer, the countercyclical capital buffer and, for ADIs designated by APRA as D-SIBs, the D-SIB buffer. Within this range, capital distribution constraints apply.

suggested that IRB capital requirements could be excessively procyclical, and as such additional flexibility to use or release buffers could be needed.

APRA's response

APRA has had detailed engagement with the ADI industry on these issues and has carefully considered the level and composition of buffers. APRA is broadly maintaining its approach to capital buffers, to deliver the objective of flexibility while also meeting internationally agreed Basel standards. Table 3 below clarifies the new capital buffers that will apply to IRB and standardised ADIs.

APRA has reduced the additional capital conservation buffer (CCB) applied to IRB ADIs from 1.5 per cent to 1.25 per cent of risk weighted assets (RWAs), to refine the calibration of the framework. Further reductions in the CCB would have compromised the calibration of the framework or other reform objectives. Other more significant changes to the design of buffers and the operation of constraints on distributions would have been challenging, without increasing complexity and compromising consistency with the Basel standards.

Table 3. Capital buffers

Capital components for CET1 (% RWA)	Standardised	Advanced	Majors (D-SIBs)
Minimum Prudential Capital Ratio (PCR)	4.50%	4.50%	4.50%
Capital Conservation Buffer (CCB)	2.50%	3.75%	3.75%
Additional CCB for major banks as D-SIBs			1.00%
Countercyclical Capital Buffer (CCyB)	1.00%	1.00%	1.00%
Total	8.00%	9.25%	10.25%

Management buffers

APRA is not defining a CET1 target for ADIs above the requirements set out in Table 3. APRA expects that ADIs will set their own targets, ensuring they maintain a prudent management buffer above the top of the CCB in normal operating conditions, to allow for business growth, volatility in profit and capital surplus, and their own dividend policy. This management buffer will vary by ADI and over time, and in practice is often defined as an operating range to account for any sizeable outflows such as dividends.

APRA expects that, during implementation in 2022, ADIs will calibrate and set their own capital targets based on the new framework. These should be developed as part of the ADI's Internal Capital Adequacy Assessment Process (ICAAPs), and would take into account a broad range of considerations in addition to regulatory buffer requirements.[4]

[4] Capital targets should be calibrated based on a range of considerations, including risk appetite, an internal assessment of capital needs arising from business plans and strategy, peer benchmarking, rating agency assessments (where relevant), and access to additional capital. Further guidance is provided in *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110).

Buffer usability

In periods of stress, ADIs may operate within the regulatory buffer range so as to allow them to absorb losses and continue lending: this is the intent of the capital framework. Regulatory capital buffers are designed to be used if needed, and APRA does not expect ADIs to maintain capital ratios above the buffer range in a period of severe stress. In the draft APG 110, APRA has clarified that ADIs operating in the buffer should agree a rebuild path back out of the buffer range with APRA.

The timeframe that APRA would expect an ADI to move out of the buffer range would depend, amongst other things, on the nature and severity of the stress scenario. During a prolonged or severe stress period, an ADI's restoration timeframe out of the buffer range may be more than a year, depending on the scenario. During a milder or shorter period of stress, the restoration timeframe may be able to be quicker than this.

Procyclicality

Regulatory capital buffers are also designed to accommodate changes in capital ratios from procyclicality. In the IRB capital framework, larger regulatory buffers should help these ADIs absorb increases in risk weights that are driven by a deterioration in credit quality during stress. The IRB framework is intentionally risk sensitive and, in stress, ADIs should anticipate and plan for some increase in risk weights.

Considering the issues raised in submissions, APRA has made adjustments where appropriate to dampen the risk of excessive procyclicality, including removing scalars for defaulted residential mortgage exposures. APRA also expects that IRB ADIs, in the design of internal rating systems and rating philosophy, will aim to avoid excessive procyclicality. This could be achieved, for example, by a through-the-cycle rating philosophy and modifying inputs in rating systems to remove excessive volatility, as detailed in the draft APG 113.

1.2 IRB capital floor

In December 2020, consistent with the Basel III standards, APRA proposed an RWA floor to limit the capital benefit of modelled estimates under the IRB approach relative to the standardised approach. The capital floor applies at the aggregate RWA level and requires IRB ADIs to apply the higher of total RWA calculated under the IRB approach and 72.5 per cent of total RWA calculated under the standardised approach. The floor applies at both Level 1 and 2, and the calculation includes IRRBB and RWA multipliers.

Figure 1. Components of the capital floor

Credit Risk includes Counterparty Credit Risk, Credit Valuation Adjustment and Securitisation.
IRB approach to credit risk includes the 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.

Comments received

Respondents broadly supported the adoption of the floor, to better balance capital outcomes between standardised and IRB ADIs. Some submissions, however, suggested that the floor should apply at the asset-class or portfolio level, to further enhance competition in specific asset classes.

APRA also received feedback, based on results of the QIS study in July 2021, that the capital floor may be a binding constraint for IRB ADIs. As a result, some respondents have suggested that APRA should lower the floor level or adjust the floor calculation to account for other areas of conservatism in the framework. It was also recommended that APRA revise *Prudential Standard APS 330 Public Disclosure* (APS 330) to promote transparency on differences between the measurement of capital in Australia and the Basel III framework.

Some respondents also highlighted potential challenges in implementing the floor. Specifically, IRB ADIs will need to implement both the revised IRB and the standardised calculation in parallel. It was suggested that APRA consider a phased implementation for the floor, or allow it to be based on a best endeavour's basis for the first 12 months.

APRA's response

The capital floor is a core component of the capital framework: it limits differences in capital outcomes across the IRB and standardised approaches, and supports comparability and competition. To this end, APRA is maintaining the floor at 72.5 per cent, which will apply when APS 110 comes into effect from 1 January 2023.

Calibration of the floor

In calibrating the framework to 'unquestionably strong', APRA has been mindful of ensuring the floor acts as a backstop rather than a permanently binding constraint on a system-wide basis. A floor that is constantly binding in aggregate across ADIs would run counter to APRA's objective of preserving risk sensitivity in the IRB approach, as changes in an ADI's IRB estimates would not impact capital requirements. This could produce a material disincentive for ADIs to invest in advanced modelling approaches, and the risk management benefits that this brings.

To adjust the underlying components of the floor calculation so that it does not become binding, however, would not in APRA's view be appropriate. Adjustments to the floor calculation would produce unnecessary complexity and would not meet the minimum Basel standards.

Instead, APRA has rebalanced between capital buffers and RWA in calibrating the framework, increasing RWAs in some areas while still meeting the 'unquestionably strong' benchmarks. This has been achieved by setting the IRB RWA scalar at 1.1, consistent with the December 2020 proposal, and reducing the additional CCB for IRB ADIs to 1.25 per cent from the proposed 1.5 per cent. With these adjustments, APRA does not expect the floor to be constantly binding at a system level.

Implementation of the floor

APRA accepts that the implementation of the floor may initially present challenges for IRB ADIs, given the need to calculate RWAs using both the standardised and revised IRB

approaches. APRA is therefore allowing transitional arrangements for aspects of the capital floor:

- For the first 12 months of the floor being operationalised (1 January 2023 to 31 December 2023), APRA is open to ADIs adopting a pragmatic implementation of the standardised calculation. Specifically, IRB ADIs may apply conservative assumptions or proxies in determining standardised RWAs. This approach would need to be approved by APRA, and APRA may apply a capital overlay on an ADI's IRB and/or standardised RWA if there are concerns that the floor has been underestimated.

- Consistent with the extension in the timeline for updating *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116), IRB ADIs will be able to continue to determine market risk capital using current internal model approaches, rather than the APS 116 standard method, until 1 January 2025.

- For the aspects of the capital floor calculation that use *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)* (APS 117) and *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180), the calculation of these requirements will be based on existing requirements until the new requirements come into force on 1 January 2024 and 2025, respectively.

APRA has also provided high-level guidance in the draft APG 110 to assist in the calculation of the floor, and will consider changes to disclosure requirements when reviewing APS 330.

1.3 The simplified capital framework

The Basel III framework was designed for large, internationally active banks. As a result, certain capital requirements may not be appropriate for smaller, less complex ADIs, where the cost of implementing the Basel III framework may outweigh the benefits in prudential safety.

APRA announced in the June 2019 consultation on the capital standards an intention to develop a simplified capital framework for smaller, less complex ADIs. In December 2020, as part of the consultation on APS 110, APRA outlined additional features of this simplified framework, to further reduce cost and complexity for eligible ADIs. These additional features expanded the scope of the framework, by:

- increasing the eligibility threshold from $15 billion to $20 billion in total assets, supported by qualitative criteria set out in APS 110;

- removing reporting requirements for counterparty credit risk and for IRRBB;

- removing the leverage ratio requirement for all standardised ADIs; and

- removing public disclosure requirements set out in APS 330.

Comments received

Respondents were supportive of APRA's approach to proportionality in the capital framework, noting that the simplified capital framework would alleviate regulatory burden and reduce

operational complexities for small ADIs. In particular, submissions supported the proposed expansion of the threshold to $20 billion in total assets. However, a number of queries were raised in regards to the operationalisation of the framework. These included:

- further clarification on the qualitative eligibility criteria for the simplified framework, including in particular the requirement that eligible ADIs would not have offshore funding or non-centrally cleared derivative exposures;
- how an ADI would be notified if they are eligible for the simplified framework, how an ADI would opt-out of the framework, and whether an ADI could 'pick and choose' elements of the simplified framework; and
- a recommended reduction in the operational risk capital requirement for ADIs on the simplified framework, from 10 per cent to 8 per cent of RWA to recognise the simplicity of small ADI business activities.

APRA's response

In response to issues raised in the consultation, APRA has developed guidance on operationalising the simplified framework for small ADIs as part of the draft APG 110. The guidance includes further information on interpreting the qualitative criteria set out in APS 110. APRA will notify ADIs that are eligible to use the simplified framework before the end of the 2021. Table 4 below summarises the simplified capital framework, as finalised.

Table 4. Summary of the simplified capital framework

Risk area	Simplified requirements
Credit risk	Consistent with APS 112 standardised capital requirements
Operational risk	Simple, flat rate add-on of 10 per cent of total credit and securitisation RWAs
Counterparty credit risk (CCR)	No CCR capital requirements or reporting
Interest rate risk in the banking book (IRRBB)	No specific risk management requirements for IRRBB, with some reporting to allow supervisors to monitor the risk
Leverage ratio	No leverage ratio requirements or reporting
Public disclosures	Replacing disclosure requirements with an APRA data publication, to be confirmed during consultation in 2022

APRA considers the 10 per cent operational risk capital requirement appropriate and reflective of the level of operational risk for small ADIs. To retain simplicity, ADIs captured under the simplified framework will not be required to calculate operational risk capital under the methodology set out in *Prudential Standard APS 115 Capital Adequacy: Standardised Measurement Approach to Operational Risk* (APS 115).

Chapter 2 - Residential mortgages

This chapter outlines APRA's response to submissions on capital requirements for residential mortgages under both the standardised and IRB approaches (APS 112 and APS 113). This includes the segmentation of different types of residential mortgages, calibration of key IRB parameters, and treatment of long-term interest-only lending.

2.1 Defining higher risk residential mortgage lending

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

To segment mortgage lending, APRA has defined standard and non-standard loans, and within standard loans, lower- and higher-risk categories. These categories are consistent across both the standardised and IRB approaches. This segmentation is summarised in Table 5. Higher risk weights apply to higher risk and non-standard loans.

Table 5. Residential mortgage segmentation

Loan type	Risk	Definition
Standard	Lower risk	• Loans to owner-occupied with principal-and-interest (P&I) repayments
Other standard	Higher risk	• Loans to investors • Interest-only loans • Loans to SMEs secured by residential property (under the standardised approach)[5]
Non-standard	Highest risk	• Loans that do not meet minimum standards for enforceability, origination, valuation and documentation

Under the standardised approach in APS 112, APRA has prescribed risk weights, varying by loan-to-valuation ratio (LVR) and by whether there is lenders mortgage insurance (LMI). The risk weight schedules for standard mortgages are outlined in Table 6 below. The risk weight for non-standard mortgages would typically be 100 per cent.[6]

[5] Loans to SME secured by residential property are excluded from the IRB residential mortgage asset class.

[6] The exception is reverse mortgages with an LVR ≤ 60 per cent, to which a 50 per cent risk weight applies.

Table 6. Risk weights on standard mortgages in APS 112

Risk weights by LVR band %		LVR band						
		≤ 50	≤ 60	≤ 70	≤ 80	≤ 90	≤ 100	> 100
Standard (owner-occupied P&I)	LMI	20	25	30	35	40	55	70
	No LMI					50	70	85
Other standard (investor, interest-only and SME)	LMI	25	30	40	45	50	70	85
	No LMI					65	85	105

IRB ADIs are allowed, under APS 113, to apply risk weights based on the outcomes of internal models, subject to certain parameters:

- A risk-weight floor for residential mortgages set at 5 per cent, to limit capital differences between the IRB and standardised.[7]
- A proposed multiplier of 1.4x for lower risk mortgages (owner-occupied P&I) and 1.6x for higher risk mortgages. The multiplier was proposed to apply to both performing and defaulted exposures.
- A 20 per cent reduction in risk weights for mortgages with LVR greater than 80 per cent that have LMI, which was previously not recognised in the IRB approach.

Comments received

Submissions were generally supportive of APRA's approach to residential mortgages capital requirements, but with three key areas of feedback: LVR bands for standardised ADIs, multipliers for IRB ADIs and the level of LMI benefit.

For the standardised approach, some respondents requested additional granularity to the risk weight schedule. This included suggestions, for example, to consider further LVR bands below 50 per cent, with lower risk weights. This could be offset by even higher risk weights for higher LVR exposures.

For the IRB approach, some respondents suggested that the multipliers be recalibrated. Some submissions were of the view that the multipliers do not reflect the actual risk of further loss in these assets and could amplify procyclicality, in particular for defaulted exposures which already have high risk weights. It was requested that APRA remove the multiplier for defaulted exposures to reduce procyclicality.

Consistent with previous feedback, some respondents suggested a recalibration of the proposed settings for LMI, such as a benefit of 30-50 per cent rather than 20 per cent,

[7] The floor applies at the exposure level and as a penultimate step in the calculation (after the relevant PD, LGD and EAD floors and residential mortgage multipliers, but before the overall IRB scaling factor).

applied to all mortgages rather than just those with an LVR above 80 per cent. Respondents cited past claims experience in support of this feedback.

APRA's response

APRA is broadly maintaining its approach, consistent with the December 2020 consultation, with the exception of adjustments to the IRB multipliers.

Introducing more granular LVR bands and lower risk weights in the standardised approach would not be consistent with the Basel standards. APRA has instead introduced other measures to support more consistent outcomes between the IRB and standardised approaches, such as IRB floors and multipliers.

APRA has adjusted the IRB multiplier for 'other standard' mortgages from 1.6 to 1.7, and retained the 1.4 multiplier for standard owner-occupied P&I mortgages. This adjustment has been made to refine the overall calibration of the framework and support competition objectives. APRA acknowledges the risk that applying multipliers to defaulted mortgages could increase procyclicality, and has therefore removed the multipliers for defaulted mortgages.

Table 7. Multipliers under the IRB approach: mortgages

Multipliers	December 2020 consultation	Final standards
Standard (owner-occupied P&I)	1.4 x	1.4 x
Other (investor, interest-only)	1.6 x	1.7 x
Scope	All exposures, including defaulted	Only non-defaulted exposures

APRA has maintained the level of recognition of LMI in the IRB approach. This approach will allow greater recognition of LMI than in the current framework, and avoid undue disincentives to its use. APRA considers the 20 per cent risk-weight reduction, which applies to mortgages with an LVR above 80 per cent, to be appropriate, based on a range of factors. As outlined in the December 2020 consultation, these factors include that LMI is an insurance product subject to a claims process rather than a guarantee, the capital support is indirect and not fungible in the same way as capital held directly by the ADI, there are different levels of capital strength between ADIs and LMI providers, and LMI recovery claims have the potential to become a material concentration risk in periods of stress.

2.2 Non-standard mortgages: long-term interest-only

APRA proposed categorising 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 repayment on a P&I 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 should be applied.

Comments received

APRA received a large amount of feedback on the proposal to treat long-term interest-only loans as non-standard. Respondents argued that the proposed treatment would be unduly conservative and would not reflect the risk profile of these loans. Submissions provided information on the inherent risk associated with long-term interest-only lending, noting the arrears and default rates have steadily decreased over time as ADIs have improved serviceability assessments and tightened underwriting criteria. Some respondents also noted that the proposal may push interest-only lending to the unregulated non-ADI sector.

APRA's response

After considering industry feedback, APRA has narrowed the definition of long-term interest only lending that would be classified as non-standard. The definition is still based on mortgages with an interest-only period of greater than five years, with two amendments:

- 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 an 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 recognises the higher credit risk with long-term interest-only lending, while narrowing the definition to those more vulnerable loans.[8]

2.3 Standard mortgages: serviceability criteria

The draft APS 112 allowed APRA to 'vary or apply additional serviceability criteria' in determining a loan to be a standard mortgage, in addition to other specified minimum requirements. This additional serviceability criteria would be used to either tighten or relax requirements, to respond to market conditions.

Comments received

Some respondents requested clarification on what would constitute 'additional serviceability criteria', noting that this could result in greater complexity in the capital framework and inconsistencies across the industry unless well defined. Some submissions also highlighted that heightened systemic risks could be addressed through supervisory limits in APS 220, and the overlap in the framework would be unnecessary.

[8] Loans with an interest-only term of unspecified duration would also be included in the revised definition.

APRA's response

In response to feedback, APRA has removed the additional serviceability criteria from APS 112. Since releasing the draft standard in December 2020, APRA has published a framework for macroprudential policy. That framework will formalise APRA's ability to apply lending limits and adjust loan serviceability requirements on a clearer, more defined and more transparent basis.

2.4 Standard 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 P&I repayments. APRA considers that these loans are subject to higher risk during this period, with borrowers more likely to fall into arrears or default.

Comments received

Many respondents queried this seasoning requirement, noting that it would introduce operational complexities. Respondents were concerned with the application of the requirement and how it overlapped with the requirements for non-standard long-term interest-only lending.

APRA's response

APRA no longer intends to implement the seasoning requirement for interest-only loans. Taking into account industry feedback, this would have been overly complex to implement and removing it will help simplify the approach.

2.5 Mixed property collateral

Where a loan is secured by both residential and commercial property, and the predominant security is residential property, APRA proposed a simple and conservative approach to recognising the mixed property collateral. An ADI would be required to treat the loan as a residential property exposure, and only include the aggregated value of residential (not commercial) properties in the LVR calculation.

Comments received

Respondents recognised the higher risk profile of commercial property relative to residential property, but contended that allowing no recognition of the commercial property collateral dulled incentives for ADIs to take further security for their lending. Some submissions provided alternate options to incorporate commercial collateral, while also recognising their higher risk compared to residential property, such as a haircut approach. There were also some queries on the approach to calculating LVR for multiple properties securing multiple loans.

APRA's response

APRA has amended the approach to mixed collateral to allow the recognition of commercial property in LVR calculations, subject to a 40 per cent haircut. The haircut approach will ensure the framework differentiates between different types of collateral, while also

incentivising ADIs to take further security for their lending. APRA has included guidance on risk weight calculations for mixed collateral exposures, including multiple properties securing multiple loans, in the draft APG 112.

2.6 Community housing loans

The capital framework does not provide a specific treatment for community housing exposures under the standardised approach.[9] Given the different risk profile of community housing exposures, compared to owner-occupied P&I loans, APRA proposed that they would be risk weighted as 'other standard loans' under the standardised approach. Under the IRB approach, APRA proposed to retain the current approach which treats community housing exposures as income-producing real estate (IPRE).[10]

Comments received

Some respondents suggested that the proposed treatment would adversely affect the pricing and supply of community housing. Respondents suggested that community housing exposures should be treated as lower risk, consistent with owner-occupied P&I mortgages under the standardised approach and retail residential mortgages under the IRB approach. This was based on the low risk profile of community housing exposures and underlying social benefits of a more accommodative treatment. These loans are serviced through rental payments paid directly from Government welfare, a stable method of income even in economic downturns. Additionally, community housing providers are regulated by the National Regulatory System for Community Housing.

APRA's response

APRA is maintaining the approach of categorising community housing exposures as 'other standard loans' under the standardised approach and as IPRE under the IRB approach. This reflects the risk profile of these loans, and the lack of evidence that they are akin to owner-occupied P&I mortgages. APRA's view is that this treatment for these exposures is unlikely to lead to an increase in capital requirements in aggregate for community housing loans: under the revised APS 113, ADIs will be allowed to use internal models for IPRE exposures, and to the extent that lending to community housing providers is lower risk, this would further be reflected in lower PD estimates.

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[9] Community housing exposures are risk weighted depending on the predominant collateral used to secure the loan. In most cases, community housing exposures are secured by the underlying residential property and would therefore be treated as a residential property exposure, receiving a risk weight determined by its LVR.

[10] The revised framework has removed the slotting approach for IPRE and now treats IPRE as commercial property, using internal models to calculate appropriate risk weights for exposures.

Chapter 3 - Other exposures under the standardised approach

This chapter outlines APRA's response to submissions on capital requirements for exposures other than residential mortgages under the standardised approach. APRA has finalised APS 112 and released a marked-up version relative to the December 2020 draft.

3.1 Commercial property

APRA proposed to incorporate in APS 112 the Basel III definitions of commercial property, which distinguishes borrowers based on their dependency on property cash flows, with minor adjustments to align with the Australian context.

Comments received

Some respondents highlighted that the incorporation of the commercial property definitions in APS 112 would create misalignment in asset classes with APS 113. In particular, respondents noted that the APS 112 definition of commercial property of 'dependent on property cash flows' did not incorporate requirements for cash flows to be 'material' or 'primary'. The absence of these terms would mean the scope of the asset class would expand, and would be inconsistent with APS 113.

APRA's response

APRA is amending the definition of commercial property in APS 112, to better align the respective asset class with APS 113. The definition of 'commercial property dependent on cash flows' now explicitly refers to exposures where the prospect of repayment depends 'primarily' on the cash flows generated by the property.[11] APRA has also provided guidance and examples, in the draft APG 112, to support the segmentation of commercial property exposures.

3.2 Land acquisition, development and construction

APRA proposed that land acquisition, development and construction (ADC) exposures would exclude loans secured by residential property that would become the primary residence of the borrower (future owner-occupied). These loans were instead proposed to be treated as a standard mortgage, as allowed as a national discretion in the Basel III framework. Under the Basel framework, while other residential ADC loans to individuals can be treated as non-standard mortgages, APRA instead retained these loans in the broader ADC capital treatment. ADC exposures are typically risk weighted at 150 per cent, apart from for

[11] Although the definitions are now more closely aligned, there will still be some general differences in asset classes between the two approaches given that, unlike the IRB approach, the standardised approach is based on the type of collateral used to secured the exposure.

residential ADC exposures, where the risk weight may be lowered to 100 per cent on meeting certain criteria.

Comments received

Some respondents recommended extending the exemption for ADC exposures to investors. Respondents argued that APRA's approach was too conservative, and the ADC categorisation would not be appropriate for an individual investor intending to build a property to rent out. Additionally, the requirement may lead to borrowers providing false indications that they expect to occupy the property to avoid a higher interest rate driven by a higher capital treatment.

APRA's response

APRA considers it appropriate to maintain the current approach to ADC exposures, including the exemption from this classification for individuals where the loan is secured by residential property that will be the primary residence of the borrower. This provides a consistent approach to the risks of property development for investment purposes. Compared to the previous consultation, APRA has also simplified the criteria to be eligible for a 100 per cent risk weight, by no longer requiring ADIs to have a policy to assess pre-sales for loans less than $5 million in size.

3.3 Project finance exposures

The Basel III standards provide a narrow criterion for the classification of project finance exposures, including a separation of project finance exposures into 'operational phase' and 'high quality'. Respondents to the previous APRA consultation on the capital reforms highlighted multiple issues with the Basel approach, and requested simplification to ensure the criterion is suited to the Australian market.

In response, in the December 2020 consultation, APRA proposed to remove the different categories of project finance exposures and replace these with a single category risk weighted at 110 per cent, which was determined based on QIS data. This approach also maintained broad equivalence with the Basel III framework.

Comments received

Respondents requested that APRA allow ADIs the ability to either apply the more complex Basel criterion or the simplified APRA criterion when risk weighting project finance exposures. The flexibility would allow ADIs to apply more granular risk weights across the portfolio, which would reduce potential market distortions that may occur with a single risk weight.

APRA's response

Given the Basel III approach to project finance is not well suited to the Australian market, APRA considers it appropriate to retain the simplified approach to risk weighting project finance exposures. Considering the relatively small size of project finance portfolios in Australia, which are mainly held by IRB ADIs, APRA does not consider the risk of a single risk weight creating distortions in the market to be material. The benefits of the simplified approach outweigh the complexities of the alternative approach.

3.4 SME exposures

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. This maximum aligns with the threshold under the Basel III standards, accounting for currency conversion.

Comments received

Some respondents requested that APRA increase the SME retail threshold from $1.5 million to $3 million, to align the definition of SMEs with the ABA Banking Code of Practice. Respondents stated that a higher threshold would contribute to cheaper SME lending.

Submissions also suggested that the criteria for defining an SME exposure under APS 112, where the total consolidated annual revenue for the group is 'less than or equal to' $75 million, be aligned with the definition under APS 113, where the total consolidated revenue for the group is 'less than' $75 million. Similarly, respondents suggested removing the requirement in APS 112 for consolidated annual revenue from the most recent financial year. Alignment of asset class definition would improve comparability between the IRB and standardised approaches.

APRA's response

APRA is retaining the SME retail threshold of $1.5 million. An increase in the threshold for SME retail exposures to $3 million would not be consistent with Basel III standards.

APRA is aligning the total consolidated revenue requirements for SME exposures under APS 112 with APS 113. Both standards will have the same requirement to categorise exposures to corporate counterparties with total consolidated annual revenue of 'less than' $75 million as SME exposures. Additionally, where a corporate counterparty's consolidated annual revenue cannot be determined and the exposure is less than $5 million, APRA is allowing ADIs to treat the exposure as SME. Section 4.5 details other changes that APRA has made for the definition of SME retail for IRB ADIs.

3.5 Subordinated debt

APRA proposed a revised definition of subordinated debt, with a risk weight of 150 per cent for holdings of subordinated debt issued by commercial (non-financial) entities. The simplified definition originally captured facilities that are expressly subordinated to another facility.

Comments received

Respondents suggested greater alignment between the definition of subordinated debt under the standardised and IRB approaches, noting alignment would improve comparability and simplify the approach for IRB ADIs. Respondents also sought clarification on the treatment of subordinated debt exposures where the issuer is a financial institution.

APRA's response

APRA has now expanded this definition to include economic subordination, recognising the inherent risk associated with such exposures. The definition under APS 112 now aligns with

APS 113, which will simplify the approach for IRB ADIs for the purposes of the capital floor. Consistent with APS 111, subordinated debt issued by a financial institution would be a capital deduction.

For the purposes of identifying subordinated debt, ADIs will be allowed to adopt materiality thresholds. IRB ADIs will be required to have a documented policy that details its definition of subordination and can introduce materiality thresholds within this. While there is no requirement for a documented policy under the standardised approach, the draft APG 112 notes that this is better practice if ADIs adopt a materiality threshold for identifying subordinated debt.

3.6 Lease exposures

APRA has previously highlighted prudential concerns regarding ADIs holding significant exposures to physical assets where the capital held for such risks is not commensurate with the asset valuation and concentration risks. APRA proposed that lease exposures would be subject to a risk weight of 100 per cent, consistent with the risk weight under the existing APS 112. A higher risk weight would also apply to the residual value component if the ADI's aggregate residual value exposure exceeded a prescribed threshold.

Comments received

Respondents suggested that the capital treatment for lease exposures, aside from the residual value component, could be modified to be more risk sensitive. For example, APRA could more closely align with APS 113, where lease exposures are treated similar to unsecured exposures to a counterparty.

APRA's response

To achieve greater consistency across APRA's capital framework, APRA has simplified the treatment of lease exposures in APS 112. APRA has removed the 100 per cent risk weight for lease exposures, aside from the residual value component of these exposures. An ADI would instead apply the risk weight of the counterparty for its lease exposures. The residual value component of lease exposures will continue to be subject to higher risk weights.

3.7 Conditions precedent

APRA proposed to implement the Basel III definition of commitment. This included an arrangement offered by the ADI and accepted by the borrower to extend credit, purchase assets or issue credit substitutes.

Comments received

Respondents noted that the proposed definition of commitment would capture arrangements involving conditions precedent and questioned if this was intended. Submissions highlighted that including commitments subject to material conditions precedent could potentially place Australian ADIs at a competitive disadvantage. Under APRA's proposal, capital would need to be held at the time of acceptance, irrespective of the time to financial close or cancellation due to circumstances outside of an ADI's control.

APRA's response

APRA considers that it would be prudent to treat exposures with conditions precedent as commitments, given these may involve circumstances outside of the control of the lender and result in a credit exposure arising at any point in time. APRA has amended APS 112 to clarify that these arrangements would be classified as commitments where they include conditions to be met by the borrower or third parties prior to a drawdown.[12] APRA considers that this approach is consistent with the Basel III framework. The draft APG 112 provides examples of when an arrangement should be considered as accepted.

3.8 Other off-balance sheet commitments

There were a range of additional issues raised on the proposed definition of off-balance sheet commitments, as outlined in Table 8 below.

Table 8. Other off-balance sheet commitments

Issues	Comments received	APRA response
Intraday limits	Some respondents suggested that the proposed definition of an off-balance sheet commitment should exclude intraday limits that are provided to business clients for facilitating electronic payments.	APRA accepts that no capital needs to be held for these exposures, but intraday limits should be considered commitments for the purpose of APS 112, and other relevant standards, subject to a zero per cent CCF. The new APS 112 reflects this approach, and the draft APG 112 clarifies that these exposures would be risk weighted as drawn credit exposures if they remain uncleared at the end of the day.
Self-liquidating trade facilities	Some industry respondents suggested that the proposed definition of an off-balance sheet commitment should exclude self-liquidating trade facilities.	APRA notes that self-liquidating trade letters of credit, which is a common form of trade facility, would be recognised as commitments by the Basel III framework and receive a favourable 20 per cent CCF. APRA is not convinced that self-liquidating trade facilities in general should be excluded from the definition of a commitment.
Master agreements	Some respondents noted that the proposed definition of an off-balance sheet commitment would limit an ADI's	APRA is not intending to adjust the definition of commitment and believes the scope of exclusions provided in APS 112 (Attachment C, paragraph 3) to be

[12] The draft APG 112 also clarifies that in some circumstances, for example where an ADI provides commitments to fund multiple bids for the same project or where there is a condition precedent for an ADI to refinance an existing loan, the commitment to be risk weighted should be the one that results in the largest risk-weighted asset outcome. This is to prevent a duplication of capital requirements for what is, effectively, a single end exposure.

Issues	Comments received	APRA response
	ability to provide certainty relating to future finance availability for customers.	sufficient. However, APRA has provided guidance in the draft APG 112 to clarify the treatment.
Margin lending	Some respondents raised concerns about the proposed treatment of margin lending exposures, highlighting a material increase in RWA for the portfolio.[13] This could lead to the cancellation of inactive and under-utilised retail lending facilities, or the application of an unutilised facility fee on retail margin lending. Respondents suggested APRA retains the current approach of a zero per cent risk weight for undrawn margin lending facilities.	In response to feedback, APRA has adjusted the definition of a commitment to clarify the approach for margin lending. This will align with the existing definition of a 'credit limit' used in APRA's reporting standards.
Exclusions from the definition of commitment	Some respondents suggested excluding arrangements from being classified as commitments where the ADI receives external valuation fees, external legal fees and external advisory fees (e.g. to cover the cost of due diligence). The draft APS 112 excluded certain arrangements from commitments where an ADI receives no fees or commissions to establish or maintain the arrangement. The collection of fees by an ADI on behalf of a third-party service provider would also be exempt.	APRA has amended APS 112 to exempt the receipt of external valuation fees, external legal fees and external advisory fees from meeting the definition of commitment. The presence of these fees alone would not indicate a commitment as they are simply passed from the customer to pay the third-party, rather than collected and stored by an ADI.

CCF transaction types

Some respondents sought further clarification on the boundaries of specific CCF categories:

- Respondents queried APRA's decision to split the Basel category of '*forward asset purchases, forward deposits and partly paid shares and securities, which represent commitment with certain drawdown*' into two categories. Specifically, respondents sought clarity on which exposures would be captured as a 'commitment with certain drawdown'.
- Respondents also asked APRA to consider the re-inclusion of a dedicated 'unconditionally cancellable' CCF of 10 or 20 per cent. The removal of 'unconditionally cancellable' would significantly increase CCFs for applicable exposures to 40 per cent under the 'other commitments' category, which was viewed as overly conservative.

[13] APRA proposed that the undrawn portion of a margin lending exposure should receive a 40 per cent CCF, consistent with the treatment of 'other commitments' under both the standardised and IRB approaches. These exposures would not meet the criteria to be considered uncommitted facilities.

- Respondents generally welcomed a reduction in CCFs for mortgages under the standardised approach to 40 per cent, although this may contribute to a significant increase in RWAs for ADIs who have classified mortgage redraws as 'unconditionally cancellable' under the existing standards.

The draft APG 112 clarifies that a 'commitment with certain drawdown' would typically include an exposure where a loan is approved but not yet advanced, such as development exposures whereby the ADI advances funds at the completion of each stage. Further, merchant acquiring exposures (MAE) would be classified as 'direct credit substitutes' given these exposures to merchants have elements of credit substitutes and there is a positive correlation between the risk of loss to the ADI and the merchant's creditworthiness.

APRA has not reintroduced the unconditionally cancellable category of commitment. There was little evidence provided during the consultation that suggested exposures to be categorised as such were actually unconditionally cancellable. APRA has provided further guidance on the categorisation of off-balance sheet exposures in the draft APG 112 to help ADIs correctly attribute CCFs to their off-balance sheet exposures.

3.9 External ratings

Consistent with the Basel III standards, APS 112 does not allow ADIs to use external ratings for bank counterparties that include adjustments for implicit government support. ADIs must only use risk weights that are derived from the stand-alone credit rating of the counterparty.

Comments received

Some respondents queried this proposal, noting that excluding implicit government support is not currently the market practice for External Credit Assessment Institutions (ECAIs). Additionally, using an external rating based on a bank counterparty's stand-alone credit rating could be overly conservative. Some respondents requested guidance on how to remove the implicit government support assumption from external credit ratings.

APRA's response

APRA has retained its original position, consistent with the Basel III standards.[14] APRA has confirmed in the draft APG 112 that it expects ADIs to utilise external ratings that exclude implicit government support. If unavailable, APRA expects ADIs to make appropriate adjustments to external ratings such that they do not reflect implicit government support. This may include assumptions based on rating methodologies provided by ECAIs.

APRA is not intending to prescribe a specific methodology for excluding implicit support, given the reliance of this assessment on the nature of an ECAI's rating approach. That said, APRA welcomes submissions from ADIs and ECAIs on any additional guidance that may assist the implementation of the requirement.

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[14] To simplify implementation, APRA has removed the requirement for ADIs to apply solicited external ratings in relation to sovereign exposures.

Chapter 4 - IRB approach

This chapter outlines APRA's response to submissions on the proposed revisions to APS 113, following consultation. Having considered industry feedback, APRA has finalised APS 113 and released a marked-up version relative to the December 2020 draft.

4.1 IRB scaling factor

APRA proposed an IRB scaling factor of 1.1 to calibrate capital outcomes consistent with the 'unquestionably strong' benchmarks. The scaling factor would apply to credit RWAs for all IRB asset classes.

Comments received

Some respondents viewed the IRB scaling factor as conservative, and suggested it could impact international comparability and competition in overseas markets. It was recommended that APRA remove the scaling factor for wholesale exposures.

APRA's response

APRA's QIS has shown that an IRB scaling factor of 1.1 is required to meet the unquestionably strong benchmarks, risk sensitivity and competition objectives. The use of scalars supports transparency and comparability, compared to other options such as embedding conservatism in the risk-weight functions themselves, and is also consistent with APRA's intention for the IRB capital floor to act as a backstop rather than a binding constraint.

The scaling factor will apply to RWAs for all IRB asset classes, except for exposures under the supervisory slotting approach and the aggregate residual value of lease exposures which are subject to equivalent risk weights under APS 112. These exclusions are applied on the basis that the capital requirements for these exposures are already appropriately calibrated.

4.2 Offshore exposures

APRA proposed that IRB requirements would apply to the exposures of overseas banking subsidiaries that form part of the Level 2 group, with the exception of New Zealand subsidiaries. For these subsidiaries, ADIs would use equivalent requirements set by the Reserve Bank of New Zealand (RBNZ) to calculate credit RWAs, instead of APRA's requirements. This approach was intended to simplify capital calculations and reduce operational burden.

Comments received

Submissions contended that the proposal for these subsidiaries to calculate IRB requirements using credit RWAs was conservative, and suggested that APRA modify its proposal. For example, some submissions suggested that APRA remove the requirement to use RBNZ's overall IRB scalar and capital floor in Level 2 calculations. There was also a suggestion that APRA remove the exemption for New Zealand subsidiaries altogether, and

allow these subsidiaries to apply APRA's IRB requirements at Level 2. This would be on the basis that the capital frameworks are calibrated to different objectives. Some respondents also queried the scope of the credit RWA calculation that would be based on RBNZ prudential rules (for example, whether the measurement of counterparty credit risk would also be based on RBNZ prudential rules for the purpose of calculating credit RWA under APS 112 and APS 113).

APRA's response

APRA has refined its approach to reflect feedback from industry. For New Zealand banking subsidiaries, ADIs will use IRB credit-risk capital requirements set by the RBNZ, but will not apply the RBNZ IRB RWA scalar and floor. Instead, ADIs would apply APRA's IRB scaling factor of 1.1 and floor of 72.5 per cent across the Level 2 group.

The revised approach balances the need to calibrate capital outcomes to 'unquestionably strong' at both Levels 1 and 2, across the system, whilst reducing operational burden for ADIs calculating regulatory capital. As set out in the draft APG 113, APRA is also intending to allow ADIs to notify APRA of changes to its IRB systems, estimates and models in New Zealand, where such changes have been approved by the RBNZ, instead of requiring duplicative approval from APRA.

The draft APG 113, and likewise draft APG 112, clarify that these overseas banking subsidiaries would apply the RBNZ's equivalent prudential rules for measuring counterparty credit risk exposures, for the purpose of the credit risk RWA calculation under APS 113 and APS 112. In 2022, APRA will consult on consequential amendments to the broader capital framework, including APS 180, to consider if further simplification is required.

4.3 Sovereign LGD

APRA proposed that all sovereign exposures would be subject to the FIRB approach. Specifically, for senior unsecured sovereign exposures, 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.

Comments received

Some submissions expressed concern around potential cliff effects for sovereign exposures. For example, it was highlighted that a one notch downgrade for an A rated sovereign exposure could result in a material RWA increase. This is despite AAA to A sovereign obligors being highly unlikely to jump to default, with any defaults likely to be technical in nature. It was recommended that APRA include a second LGD category for A rated exposures to reduce potential cliff effects and procyclicality.

APRA's response

To mitigate the cliff effects identified by submissions, APRA will introduce an additional LGD category for A+ and A rated exposures, with a prescribed LGD of 25 per cent. In addition, ADIs will apply a 25 per cent LGD for unrated exposures to Australian local councils and a 50 per cent LGD for all other sovereign exposures, including those that are unrated. This approach is reflected below in Table 9.

Table 9. Sovereign LGD estimates

LGD %	AAA to AA-	A+, A and unrated Australian local councils	Other (including unrated counterparties)
December 2020 consultation	5	50	
Final APS 113	5	25	50

The sovereign LGD estimates in Table 9 apply to senior unsecured exposures. For sovereign exposures secured by eligible collateral, the revised APS 113 allows an ADI to adopt the lower of the sovereign LGD estimates (for unsecured exposures) and the LGD produced by the FIRB LGD formula for recognising eligible collateral. This approach ensures that collateral is appropriately recognised in these exposures. The draft APG 113 provides guidance on the calculation.

4.4 Other physical collateral

Under the FIRB approach, APRA proposed a category of exposures to be treated as 'Other eligible physical collateral'. To be eligible for this category, the physical collateral was required to have liquid markets and be supported by publicly available market prices. The proposed FIRB LGD for this category would be set at 30 percent, with a haircut of 40 per cent.

Comments received

Submissions recommended that the FIRB LGD estimate for the category be modified from 30 to 25 per cent in line with the Basel III standards. It was also suggested that APRA broaden the eligibility criteria for this category relating to liquid markets, publicly available market prices and physical inspection of collateral; this would allow the inclusion of collateral such as aircraft, ships and rail, on the basis that these exposures may retain strong value in default.

APRA's response

In response to submissions, APRA has revised the supervisory LGD for 'Other eligible physical collateral' from 30 to 25 per cent. As outlined in Table 10, APRA has also introduced a new category for exposures with eligible recovery value (that do not meet the criteria in APS 113 for 'other eligible physical collateral') and Australian water entitlements. This category would include senior exposures to operators of large public infrastructure assets or utilities that provide essential service to the economy.[15]

[15] APRA does not consider that self-liquidating trade finance facilities should qualify for a 40 or 45 per cent LGD at this stage, because of substantial losses in trade finance due to underinvestment in systems and controls.

Table 10. Supervisory estimates for eligible exposures

Category	LGD %	Collateral haircut %
Other eligible physical collateral	25	40
Exposures with eligible recovery value and Australian water entitlements[16]	Exposure to FI: 45 Exposure to Corporate: 40	40

APRA has also made additional changes to APS 113 to allow for a more practical implementation of the criteria for the 'other eligible physical collateral' category. ADIs will be required to develop their own frameworks for assessing physical collateral and maintain a register of physical collateral. Other changes include:

- **Publicly available market prices:** Publicly available market prices, for the purpose of physical collateral, may include valuations available for purchase from independent third-party appraisers. The ADI, however, must consider the credibility of the appraiser and the reliability of their appraisals.
- **Liquid markets:** Financial markets may not be the appropriate benchmark for assessing the liquidity of markets for physical assets. ADIs may assess the liquidity of markets based on internal policies and the attributes of the asset, including the degree of customisation or standardisation, condition and reusability, and time to transaction.
- **Physical inspection:** Instead of requiring annual physical inspections of inventories and equipment, ADIs may monitor the value of collateral (on at least an annual basis). ADIs must have the right to physically inspect the collateral, and define triggers for physical inspection.

4.5 Other APS 113 changes

APRA has also made a number of other changes to APS 113 to incorporate feedback from submissions, as outlined in Table 11 below.

[16] No collateral haircut will apply for senior exposures to operators of large public infrastructure assets or utilities that provide essential services to the economy, and have tripartite arrangements with the Commonwealth or are valued based on regulatory asset base.

Table 11. Other APS 113 changes

Issues	Comments received	APRA response
SME retail definition	APRA proposed that ADIs use audited financial statements to determine if a borrower meets the SME threshold of $75 million. Respondents highlighted difficulties with procuring audited financial statements from some SMEs.	To simplify implementation, APRA has removed the requirement for audited SME financial statements. The requirement for audited financial statements will remain for large corporates and financial institutions.
SME retail complex criteria	APRA proposed that SME retail exposures and borrowers are non-complex. Some respondents requested clarity on the criteria.	ADIs may rely on internal definitions of complexity. The draft APG 113 includes factors that the ADIs should consider.
Groups of connected borrowers	APRA proposed that ADIs should use the definition of a group of connected counterparties, in APS 221 to determine connected SME borrowers. Some submissions noted that this could lead to unintended capital outcomes.	The revised APS 113 retains the reference to APS 221, however, only requires aggregation based on 'control' and 'single risk' relationships. In the event there are multiple borrower groupings, a borrower may be assigned based on the control relationship.
Retail classification	APRA proposed that retail residential mortgages and the QRR IRB sub-asset class would include exposures that are 'not for business purposes'. Submissions requested clarity on how this should be interpreted.	APRA has provided guidance in the draft APG 113 to align with the definition of business purpose in the National Credit Code. The draft APG 113 also clarifies that QRR transactors exclude zero balance transfers and borrowers which only pay off minimum balances.
Purchased defaulted exposures	APRA proposed that EAD for defaulted exposures purchased by an ADI would be set to the purchase price, and the discount must be set equal to zero. It was recommended that this be amended to the exposure's carrying value to ensure greater risk sensitivity.	The final APS 113 reflects the changes proposed in submissions.
Financial receivables	APRA proposed a number of conditions for an ADI to recognise financial receivables as eligible collateral under FIRB.	The final APS 113 clarifies that an ADI must be able to realise collateral within a reasonable timeframe.
Public sector entities	APRA proposed treating domestic public sector entities (PSEs) as financial institutions under APS 113. Other PSEs were to be treated under the corporate IRB asset class.	The final APS 113 classifies all PSE exposures as corporate exposures, for simplicity. The draft guidance also provides some indicators to assist ADIs in classifying entities as PSEs and domestic PSEs.

Chapter 5 - Consultation on draft PPGs

Alongside this response paper, APRA is releasing draft versions of revised guidance, for consultation: APG 110, APG 112 and APG 113. These PPGs provide guidance on implementing the respective capital standards, and have been developed to address queries raised by industry in consultations and guidance from the Basel Committee on Banking Supervision. APRA welcomes any feedback on the draft PPGs through the consultation process.

5.1 Draft APG 110

The draft APG 110 aims to assist ADIs in meeting the requirements set out in APS 110 on overall capital management, in order to maintain adequate capital to act as a buffer against the risk associated with activities. The draft guidance includes further information on the operation of capital buffers and constraints on capital distributions, the calculation of the capital floor and the simplified capital framework.

5.2 Draft APG 112

The draft APG 112 provides guidance on the implementation of the standardised approach to credit risk. It covers the classification and calculation of capital requirements for property exposures, non-property exposures and off-balance sheet commitments, and the application external credit ratings and credit risk mitigation. It also includes examples to assist ADIs in implementing the revised requirements, and detailed asset class definitions to assist ADIs in categorising exposures.

5.3 Draft APG 113

The draft APG 113 provides guidance relating to the implementation of the IRB approach. It outlines expectations for governance and oversight, IRB-specific asset classes, modelling, the application of risk-weight functions and risk components, and the validation and monitoring of IRB models. It also includes detailed guidance for ADIs seeking to obtain approval for the use of the IRB approach.

5.4 Request for submissions

APRA invites written submissions on the draft APG 110, APG 112 and APG 113. Written submissions should be sent to ADIpolicy@apra.gov.au by 11 March 2022 and addressed to the General Manager, Policy, APRA.

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.

Annex A – Summary of the reforms

The table below summarises the changes in the ADI capital standards as a result of APRA's reforms.

Capital reforms	Current framework	New framework
Capital adequacy	**Standardised ADIs** PCR: 4.5% CCB: 2.5% CCyB: 0% default level	**Standardised ADIs** PCR: 4.5% CCB: 2.5% CCyB: 1.0% default level
	IRB ADIs PCR: 4.5% CCB: 2.5% CCyB: 0% default level D-SIB: 1.0% (major banks)	**IRB ADIs** PCR: 4.5% CCB: 3.75% CCyB: 1.0% default level D-SIB: 1.0% (major banks)
Residential mortgages	**Standardised ADIs** Segmentation by 'standard' and 'non-standard' loans. Lowest risk weight available is 35%.	**Standardised ADIs** Segmentation by 'standard' and 'non-standard' loans, and by risk inherent in loan purpose (owner-occupied P&I, and other). Lowest risk weight available is 20%.
	IRB ADIs Correlation factor adjustment to narrow the difference to the average risk weight under the standardised approach. 20% LGD floor, no risk weight floor. No recognition of LMI.	**IRB ADIs** Multipliers instead of correlation factor adjustments, which specifically target higher risk mortgage segments in line with the standardised approach. 10% LGD floor, 5% risk weight floor. Recognition of LMI.
Lending to SMEs	**Standardised ADIs** No recognition of commercial property security. SME lending, not secured by property, 100% risk weight.	**Standardised ADIs** Risk weights vary by level of commercial property security. SME lending not secured by property receives a 75% risk weight if less than $1.5m in size, otherwise 85% risk weight.
	IRB ADIs Retail SME approach for lending less than $1m in size.	**IRB ADIs** Retail SME approach for lending less than $1.5m in size.

Capital reforms	Current framework	New framework
	Corporate SME approach for annual turnover less than $50m.	Corporate SME approach for annual turnover less than $75m.
Other credit portfolios	**Standardised ADIs** Largely aligned with Basel framework.	**Standardised ADIs** Largely aligned with Basel framework.
	IRB ADIs Overall scalar to credit RWA of 1.06x. Higher risk estimates compared to overseas peers for the corporate portfolio and limited use of models for commercial property exposures.	**IRB ADIs** Overall scalar to credit RWA of 1.1x. Reduction in gap to risk estimates relative to overseas peers, models allowed to calculate capital requirements for commercial property exposures.
New Zealand	Risk weights determined on an APRA basis, with input parameters approved by Reserve Bank of New Zealand (RBNZ).	Risk weights determined on an RBNZ basis, but with APRA's overall IRB scalar and floor.
Proportionality	No threshold for simplified requirements and all ADIs subject to materially similar reporting requirements.	Smaller, less complex ADIs can benefit from simplified requirements. This includes a simple operational risk capital requirement of 10 per cent of RWA, no capital requirements for counterparty credit risk or interest rate risk in the banking book, and no leverage ratio or disclosure requirements.
Comparability	No floor on RWA differences between standardised and IRB approaches.	IRB RWA requirements cannot fall below 72.5% of RWA calculated under standardised approaches.

Annex B – Comparison with Basel III

One of APRA's objectives through the reforms has been to ensure the ADI capital standards are at least equivalent to the minimum standards in the internationally-agreed Basel III framework. The table below provides a summary comparison of the ADI capital standards with the Basel III framework. APRA intends to undertake a more thorough international comparability study in 2022, to analyse differences between capital requirements in Australia and international peer jurisdictions.

Topic	APRA standards	Equivalence	Basel III framework
Capital adequacy	**Standardised ADIs** PCR: 4.5% CCB: 2.5% CCyB: 1.0% default level	=	**Standardised ADIs** PCR: 4.5% CCB: 2.5% CCyB: No default level
	IRB ADIs PCR: 4.5% CCB: 3.75% CCyB: Range of 0% to 3.5%, with a 1.0% default level D-SIB: 1.0% (major banks)	↑	**IRB ADIs** PCR: 4.5% CCB: 2.5% CCyB: Range of 0% to 2.5% D-SIB: N/A G-SIB: Range of 1% to 3.5%
Residential mortgages	**Standardised ADIs** Segmentation by 'standard' and 'non-standard' loans, and by risk inherent in loan purpose (owner-occupied P&I, and other). Lowest risk weight available is 20%.	↑	**Standardised ADIs** Segmentation depending on whether repayments are materially dependent on the cash flows generated by the property. Lowest risk weight available is 20%.
	IRB ADIs Multipliers instead of correlation factor adjustments, which specifically target higher risk mortgage segments in line with the standardised approach. 10% LGD floor. 5% risk weight floor.	↑	**IRB ADIs** Correlation factor adjustment of 15% across the whole residential mortgage portfolio. 10% LGD floor. No risk weight floor.

Topic	APRA standards	Equivalence	Basel III framework
Lending to SMEs	**Standardised ADIs** SME lending not secured by property receives a 75% risk weight if less than $1.5m in size, otherwise 85% risk weight.	=	**Standardised ADIs** SME lending not secured by property receives a 75% risk weight if it meets the requirement of a retail exposure, otherwise 85% risk weight.
	IRB ADIs Retail SME approach for lending less than $1.5m in size. Corporate SME approach for annual turnover less than $75m.	=	**IRB ADIs** Retail SME approach for lending less than €1m in size. Corporate SME approach for annual turnover less than €50m.
Other credit portfolios	**Standardised ADIs** Largely aligned.	=	**Standardised ADIs** Largely aligned.
	IRB ADIs Overall scalar to credit RWA of 1.1x	↑	**IRB ADIs** No scalar applied.
Proportionality	Smaller, less complex ADIs can benefit from simplified requirements. This includes a simple operational risk capital requirement of 10 per cent of RWA, no capital requirements for counterparty credit risk or interest rate risk in the banking book, no leverage ratio requirement or disclosure requirements.	=	Supports a proportional implementation of the Basel framework, where it complies with the Basel Core Principles.
Comparability	IRB RWA requirements cannot fall below 72.5% of RWA calculated under standardised approaches.	↑	A phased implementation of the capital floor, beginning with 50% from 1 January 2023, increasing to 72.5% by 1 January 2028.

Other technical differences between the APRA standards and the Basel III framework include, but are not limited to, APRA's IRB approach not being permitted for margin lending; the application of a scalar for IPRE; the application of the FI asset class instead of bank asset class; bank-specific EAD estimates being ineligible under AIRB; higher unsecured LGD estimates for corporates; no AIRB approach for sovereign exposures; a higher CCF for non-revolving retail and unconditionally cancellable; and a modified EAD and discount value for purchased defaulted exposures.

Annex C – Summary of risk weights

This section sets out a summary of the finalised risk weights and credit conversion factors for standardised ADIs. The relevant sections of APS 112 should be read to obtain the specific capital treatment for the exposure. This section covers Attachment A to C of APS 112.

Risk weight (%)	LVR	≤50	50.01-60	60.01-70	70.01-80	80.01-90	90.01-100	>100	APS 112 Ref.
Residential mortgages									
Owner-occupied principal-and-interest	LMI	20	25	30	35	40	55	70	Table 1
	No LMI	20	25	30	35	50	70	85	Table 1
Other standard residential property	LMI	25	30	40	45	50	70	85	Table 1
	No LMI	25	30	40	45	65	85	105	Table 1
Reverse mortgages		50	50	100	100	100	100	100	Table 2
All other non-standard loans		100	100	100	100	100	100	100	Table 2

Risk weight (%)	LVR	≤60	60.01-80	>80	APS 112 Ref.
Commercial property					
Dependent on property cash flows	Standard	70	90	110	Table 3
	Non-standard		150		Table 3
Not dependent on property cash flows	Rated corporate	60 or see Table 10	See risk weights in Table 10 of APS 112		Table 4
	All other counterparties	60	See Attachment B of APS 112		Table 4

Risk weight (%)	%	APS 112 Ref.
Land acquisition, development and construction		
Conditions in Attach. A Para. 29 met	100	Attach. A Para 29
All other ADC exposures	150	Attach. A Para 30

Risk weight (%)	Rating grade	1	2	3	4, 5	6	Unrated	APS 112 Ref.
Non-property exposures								
Sovereign		0	20	50	100	150	100	Table 5
Domestic public sector entities		20	50	50	100	150	50	Table 6
Bank	Short-term exposures	20	20	20	50	150	20	Table 7
	Long-term exposures	20	30	50	100	150	50	Table 7
	Short-term issue specific	20	50	100	150			Table 8
Covered bonds		10	20	20	50	100		Table 9

Risk weight (%)	Rating grade	1	2	3	4	5, 6	APS 112 Ref.
Corporate exposures							
General corporate	Long-term	20	50	75	100	150	Table 10
	Short-term issue-specific	20	50	100	150		Table 11

Risk weight (%)	%	APS 112 Ref.
SME retail	75	Table 12
SME corporate	85	Table 12
General corporate – other	100	Attach. B Para 25
Project finance	110	Table 13
Object and commodities finance	100	Table 13
Retail exposures		
Credit cards	75	Table 14
Other retail	100	Table 14
Margin lending exposures		
Eligible financial collateral	20	Attach. B Para 32
Other	100	Attach. B Para 32
Subordinated debt exposures		
Subordinated debt	150	Para 33
Equity exposures		
Listed on recognised exchange	250	Attach. B Para 38(a)
Not listed on recognised exchange	400	Attach. B Para 38(b)

Risk weight (%)	%	APS 112 Ref.
Lease exposures		
Residual value ≤10% Tier 1 Capital	100	Table 15
Residual value >10% Tier 1 Capital	250	Table 15
Exposures originated through a third party		
Exposures through a third party	150	Attach. B Para 41
Other exposures		
Cash and gold bullion	0	Table 16
Cash in the process of collection	20	Table 16
Investments in premises, plant, equipment and other fixed assets	100	Table 16
All other exposures not specified elsewhere	100	Table 16
Currency mismatch		
Risk weight multiplier for certain exposures with currency mismatch	1.5x	Attach. B Para 43

Credit conversion factors (CCF)	%	APS 112 Ref.
Direct credit substitutes	100	Table 17
Sale and repurchase agreements and asset sales with recourse	100	Table 17
Lending of securities or posting of securities as collateral	100	Table 17
Forward asset purchases, forward deposits and partly paid shares and securities	100	Table 17
Other off-balance sheet items that are credit substitutes	100	Table 17
Unsettled securities, commodities and foreign exchange transactions accounted for at settlement date	100	Table 17
Other commitments with certain drawdown	100	Table 17
Note issuance and revolving underwriting facilities	50	Table 17
Performance-related contingencies	50	Table 17
Other commitments	40	Table 17
Short-term self-liquidating trade letters of credit arising from the movement of goods	20	Table 17
Intraday limits	0	Table 17
Irrevocable standby commitments under industry support arrangements	0	Table 17

Annex D – Regulatory Impact Analysis

This section sets out APRA's regulatory impact analysis. Consistent with the Australian Government Guide to Regulation, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS). APRA's evaluation of the impact of policy changes to APS 110, APS 112 and APS 113 is provided below.

Background and objectives

Since 2018, APRA has undertaken four rounds of public consultation in revising the issues within APS 110, APS 112 and APS 113 and has engaged with a variety of stakeholders, including APRA-regulated entities, industry bodies, and other regulators.[17] This consultation commenced with the release of APRA's February 2018 discussion paper *Revisions to the capital framework for ADIs*, supplemented by an additional discussion paper in August 2018 *Improving the transparency comparability and flexibility of the ADI capital framework*. As detailed in APRA's response papers in June 2019 and December 2020, and this November 2021 responses to submissions, APRA has clarified or amended its proposals in a number of areas, following the consideration of issues raised by stakeholders.

Origins and objectives of the reforms

In its February 2018 discussion paper, APRA set out the problem and why regulatory action was needed. While Australian ADIs have traditionally been well capitalised to withstand the risks they have faced in the past, the Australian Government's 2014 Financial System Inquiry recommended, and the Government subsequently endorsed, that APRA increase capital requirements for ADIs such that they meet 'unquestionably strong' capital benchmarks. APRA also identified a number of concerns that needed to be addressed, including:

- concentration risks in the residential housing market in Australia;
- the alignment of capital and risk under the existing framework;
- ADIs' ability to compete in, and access to, international markets; and
- unnecessary regulatory burden faced by smaller, less complex ADIs.

In addition, as Australia is a member of the Basel Committee on Banking Supervision (Basel Committee), Australia is committed to meeting internationally agreed standards for prudential regulation for ADIs. The reforms of the Basel framework following the 2008 global financial crisis were strongly endorsed by the G20 (of which Australia is a member), which strongly endorsed the full, timely and consistent implementation of the standards.

[17] APRA's consultation on revisions to the ADI capital framework, along with non-confidential industry submissions, can be found here: https://www.apra.gov.au/revisions-to-capital-framework-for-authorised-deposit-taking-institutions

The two key objectives of action were therefore: (i) implementing the Basel Committee's revised capital framework as appropriate to Australia and (ii) increasing the resilience of the Australian financial sector by building 'unquestionably strong' capital benchmarks for ADIs into the new capital framework. The latter was identified as a 150 basis points and 50 basis points increase in capital requirements for ADIs on the internal risk-based approach (IRB) to capital and standardised ADIs, respectively.

In addition to these broader objectives, APRA's review also set out to make a number of key enhancements to the capital framework. These intended enhancements included:

- **flexibility:** increasing the risk sensitivity of the capital framework such that capital is appropriately allocated to risk (e.g. concentration and other risks in the residential housing market);
- **risk sensitivity:** improving the flexibility of the capital framework to make it more responsive to the economic environment (e.g. to support the ability of ADIs to absorb losses and continue lending in stress);
- **transparency** and **comparability:** improving the transparency of the ADI capital framework to enable comparisons of capital adequacy across ADIs and international peers such that they are better enabled to compete in and access funding in international markets;
- **competition:** supporting competition by limiting the differences in capital outcomes between ADIs using advanced modelling approaches relative to ADIs utilising the standardised approach; and
- **proportionality:** minimising regulatory burden for smaller ADIs without compromising prudential safety.

Summary of policy options

The February 2018 discussion paper outlined the options available to APRA in reviewing the ADI capital framework, including preliminary analysis on potential industry impacts. The sections below expand on APRA's initial analysis, taking into account feedback received during the consultation period and the impact of the final standards, APS 110, APS 112 and APS 113. As APRA is committed to meeting internationally agreed Basel standards for ADIs, the second option is considered the status-quo option.

Table 12. Summary of regulatory options

Option 1: Increase minimum CET1 capital ratios	Increase the minimum CET1 capital ratio for each ADI under APRA's current capital adequacy framework.
Option 2: Implement Basel III reforms	Modify the current capital adequacy framework through implementing the Basel III reforms relating to credit risk, operational risk, market risk, credit valuation risk and interest rate risk in the banking book.
Option 3: Implement Basel III reforms, adjusted for Australian conditions	Modify the current capital adequacy framework through implementing the Basel III reforms, adjusted to accommodate Australia-specific factors.

Assessment of regulatory costs

As part of the consultation process, APRA invited submissions on additional regulatory costs that could be incurred as a result of the three policy options under consideration. Respondents were invited to use the Australian Government's Burden Measurement Tool to assess regulatory costs. APRA has considered all relevant compliance and administration costs, including both upfront and ongoing costs, in estimating the regulatory costs of each option.

Option 1: Increase minimum CET1 capital ratios

Under option 1, APRA would raise the minimum CET1 capital ratio requirement applying to ADIs under the current capital adequacy framework to meet the unquestionably strong objective. This would be done through amendments to the minimum ratios set out in APS 110 or by increasing an ADI's prudential capital requirements (PCRs) using the existing power under APS 110. No other changes would be made to the framework.

Under this option, ADIs would revise internal processes and individual management buffers to reflect the new minimum requirements. This would only involve minor implementation costs as the internal processes around capital buffers, policies and reporting have long been established, and only minor changes would be required. This is shown in the following table.

Annual regulatory costs, averaged over 10 years				
Change in costs ($m)	**Business**	**Community organisations**	**Individuals**	**Total change in costs**
Total by sector	0.01	0	0	0.01

While option 1 would only involve minor implementation costs, most of APRA's key objectives and enhancements would not be met. It would not incorporate the Basel III reforms or more appropriately align capital with risk. For example, capital requirements for higher-risk residential mortgage lending would not be appropriately calibrated to address concentration and other risks in the Australian housing market. This option would also not improve

transparency, and it would reduce international comparability, as capital increases made by adjusting ADIs' PCRs would remain confidential and would not be publicly disclosed. In addition, the smaller ADIs could continue to be subject unwarranted regulatory burden under the current framework. Option 1 is therefore likely to produce a net cost.

Option 2: Implement Basel III reforms

Under option 2, APRA would amend the current capital framework to implement the Basel Committee's Basel III reforms. As APRA has already implemented the operational risk capital reforms, and is reviewing the market risk reforms at a later time, this option relates to APRA's reforms to capital adequacy and credit risk capital, applying these revisions to all ADIs as relevant. This option would achieve the objective of implementing the revised international framework, which would meet Australia's G20 commitments, preserve ADIs' continued ability to participate in international markets and improve international comparability.

The Basel III framework introduces new approaches to classifying exposures and sets different risk weights or capital requirements (e.g. replacing internal modelling with supervisory estimates under the IRB approach to credit risk). Implementing such changes would necessitate significant changes to systems and processes. It is expected that the bulk of the regulatory costs would be associated with implementing and maintaining capital models and reporting systems, particularly for larger ADIs who, for the first time, would be required to calculate capital requirements under the standardised approach to credit risk in APS 112. APRA estimates the cost to industry, at an annual average of around $6.0 million over the next 10 years, as shown in the following table.

Annual regulatory costs, averaged over 10 years				
Change in costs ($m)	**Business**	**Community organisations**	**Individuals**	**Total change in costs**
Total by sector	6.0	Nil	Nil	6.0

Whilst option 2 is likely to increase Australian ADI reported capital ratios, it would not have delivered the goal of unquestionably strong capital. For example, implementing the Basel III framework for residential mortgages would result in a material reduction in risk weights compared to the current framework, using a segmentation that is not considered suitable for the Australian market. This would not enable the capital framework to be sufficiently risk sensitive to mitigate risks arising from structural concentration. In addition, the Basel III framework is targeted towards large internationally active banks and, in places, is not proportional for small, less complex ADIs who may be impacted by material regulatory burden without clear prudential safety benefits. Option 2 may therefore produce a moderate net benefit.

Option 3: Implement Basel III reforms, adjusted for Australian conditions

Under option 3, APRA would use the Basel III reforms as the starting point, and implement adjustments appropriate for the Australian market. APRA's objective would still be to deliver

'unquestionably strong' capital ratios for ADIs, while balancing several other objectives such as risk sensitivity, competition, transparency and comparability and proportionality.

In general, APRA has calibrated the new capital framework to be moderately more conservative than the Basel III framework, but has also applied adjustments to simplify implementation where possible, using feedback provided by ADIs in submissions. For example, APRA has introduced larger capital buffers, modified asset class segmentations to suit the Australian market (in particular for residential mortgages, the largest asset class), and will implement a capital floor for IRB ADIs from 1 January 2023 instead of allowing a phased (and more complex) implementation. For larger ADIs, APRA has introduced changes to achieve better alignment in certain asset classes between the IRB and standardised approach to ease the burden for ADIs implementing both approaches, and is removing duplication in capital requirements and reporting for New Zealand banking subsidiaries of ADIs. APRA has also developed a simplified capital framework for small, less complex ADIs which is expected to materially reduce burden and enhance efficiency for these ADIs.

As Australia is a member of the G20, it has committed to implementing and applying the Basel III standards at a minimum. Therefore, the regulatory costs arising under option 3 are calculated as those costs which are above the regulatory costs of option 2, which are considered 'business as usual costs'. APRA's estimated regulatory costs above option 2 are below.

Annual regulatory costs, averaged over 10 years				
Change in costs ($m)	**Business**	**Community organisations**	**Individuals**	**Total change in costs**
Total by sector	1.5	Nil	Nil	1.5

Assessment of net benefits

APRA's view is that there are strong net benefits of APRA's approach to choosing option 3 in revising APS 110, APS 112 and APS 113:

- Adjustments are required to the Basel III framework to align capital to risks in the Australian market. Option 3 will allow APRA to mitigate risks arising from the structural concentration of Australian ADIs in residential mortgages, while increasing relative incentives for ADIs to lend to small- and medium-sized enterprises.
- Implementing the Basel III reforms with some transparent adjustments will enable Australian ADI capital ratios to be more easily understood by external stakeholders. Option 3 will reduce the time and effort required by ADIs to produce information to stakeholders to explain the comparability of their capital ratios. In turn, this will support ADIs in competing for funding in international markets.
- The Basel III reforms are targeted at internationally active banks. As option 3 introduces a simplified capital framework for small, less complex ADIs, this will materially lessen regulatory burden for these entities, where appropriate, without compromising

prudential safety. As this option introduce measures to limit differences across the capital framework, it will also help drive competition outcomes across ADIs.

- Finally, implementing Basel III reforms with adjustments will allow the capital framework to meet the 'unquestionably strong' capital benchmarks. This will increase the financial strength of ADIs and support the resilience of the Australian financial system. This in turn helps to protect depositors, maintain market confidence and promote financial stability, especially during potential scenarios of financial stress.

Conclusion: comparison of policy options

When developing policy, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, while promoting financial system stability in Australia. APRA considers that, on balance, option 3 will significantly enhance prudential outcomes and improve financial system safety and stability in Australia. As set out below, option 3 is expected to result in a net benefit.

	Option 1	Option 2	Option 3
Regulatory Costs	Low	Moderate	Moderate
Unquestionably strong capital	Meets this criterion	Does not meet this criterion	Meets this criterion
Basel compliance	Does not meet this criterion	Meets this criterion	Meets this criterion
Flexibility	Partly meets criterion	Meets this criterion	Meets this criterion
Risk sensitivity	Does not meet this criterion	Partly meets criterion	Meets this criterion
Competition	Does not meet this criterion	Partly meets criterion	Meets this criterion
Transparency and comparability	Does not meet this criterion	Meets this criterion	Meets this criterion
Proportionality	Does not meet this criterion	Does not meet this criterion	Meets this criterion
Overall	Net cost	Moderate net benefit	Net benefit

Implementation and review

As delegated legislation, prudential standards impose enforceable obligations on APRA-regulated institutions. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a prudential standard, including issuing a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated institution's authority to carry on its business or increasing regulatory capital requirements.

Under APRA's policy development process, reviews of new measures are typically scheduled following implementation. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards, and remain relevant and effective in facilitating sound risk management practices. APRA will also take action within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.

APRA