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General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Via email: ADIpolicy@apra.gov.au

1 April 2021

Dear Sir/Madam,

Sub: Comments on revisions to the new Capital Adequacy Prudential Standards APS 110; APS 112 and APS 113

RegCentric is pleased to provide feedback to APRA's consultation on Prudential Standards APS 110 Capital Adequacy; APS 112 Capital Adequacy: Standardised Approach to Credit Risk and APS 113 Capital Adequacy: Capital Adequacy: Internal Ratings-based Approach to Credit Risk.

RegCentric specialises in transformation in Regulatory Reporting, Finance and Risk in the Australian financial services industry. RegCentric supports a growing number of Australian financial services organisations adhere to their regulatory compliance obligations whilst driving strategic transformation. We help them leverage technology and data management best practices to drive operational efficiencies across Risk, Finance and Compliance departments. We differentiate ourselves by combining deep domain expertise in APRA regulation with technical know-how and a hands-on approach.

RegCentric welcomes APRA's initiatives to improving flexibility in the capital framework implementing more risk-sensitive risk weights and enhancing competition by generally limiting the differences between the standardised and IRB capital outcomes.

RegCentric would like to provide feedback on specific items on the proposed APS 110, APS 112 and 113 standards:

1. **Prudential Practice Guides**

   RegCentric proposes APRA to release a prudential practice guide to provide further definitions and detailed examples outlining APRA's view of what represents sound practice in particular areas. We propose that APRA look to provide industry with a prudential practice guide in relation to both APS 112 Capital Adequacy: Standardised Approach to Credit Risk and APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk.

APRA have outlined a key objective of ensuring adherence with internationally agreed Basel standards. We propose that APRA detail in these guides where APS 112 and APS 113 differ from Basel standards and the rationale for the deviations.

The release of detailed guides to industry would meet APRA's objective of more consistent classifications and treatment of credit exposures within the capital framework along with improving transparency and comparability across industry.

RegCentric also propose that APRA outline the approach to be taken to the audit of the new standards in terms of high priority items and the quality of data used in the preparation of Capital Adequacy. This would provide clarity and consistency across the industry for the audits to be conducted.

2. APS 110 Capital Adequacy

a. Capital Floor

RegCentric note that APRA are proposing that a Capital Floor on total risk weighted assets of 72.5% on IRB banks will apply from 1st January 2023. Could APRA please clarify why a phased implementation approach was not being adopted by APRA consistent with overseas jurisdictions. This may have the unintended consequence of adversely impacting the introduction of the new APS 112 rules on IRB banks.

b. Simplified Framework

RegCentric is supportive of the increase in quantitative threshold to $20 billion in total assets along with other criteria for an ADI to be eligible under the simplified approach. We note that APRA will retain the discretion to require a small ADI to use the more complex framework where appropriate. RegCentric request that APRA provide further guidelines or details about which quantifiable criteria APRA will use to deem appropriate for an ADI to move to the more complex framework.

c. Transition from the Simplified Framework

RegCentric recommend that APRA provide clear guidance to ADIs on any transition from the simplified framework. Can APRA provide details on how much time ADIs would be granted to transition from the simplified framework and what the process and requirements are in transitioning.

3. APS 112 Standardised Credit Risk

a. Standard vs Non-Standard

RegCentric notes that the criteria in APS 112 Attachment A paragraph 3 to 7 is more detailed than previous standards in the areas of enforceability, serviceability and valuation. Although ADI's would have in place policies and operational processes to capture the criteria for meeting these requirements it is not clear how this will be enforced by APRA. Can APRA clarify if it expects auditors to form an opinion on these matters?

b. Capturing of Undrawn Commitments in LVR calculations

RegCentric note the ongoing requirement to include undrawn commitments in the calculation of the Loan to Value Ratio as per paragraph 10 of Attachment A along with the requirement to capture undrawn commitments as per paragraph 3 Attachment C.

Paragraph 3 (e) of Attachment C specifically excludes *Other Commitments* where they relate to a *Corporate Counterparty*. Therefore, redraws and equity line of credit to individuals are now captured as Off-Balance Sheet Commitments.

The inclusion of redraws and equity lines of credit has a material impact on the credit risk weighted assets if included in both the LVR calculation and off-balance sheet commitments. This will have an adverse impact on several standardised ADIs credit risk and therefore capital position. RegCentric propose that APRA consider - if the undrawn component of redraws and equity line of credit are to be included in the LVR - that the same conversion factor (currently 40%) be applied in the LVR calculation to that used for *Other Commitments* in order to minimise the impact of their inclusion.

Example:

Principal Outstanding	Redraw facility	Valuation	Current LVR	Proposed LVR
1,000,000	500,000	2,000,000	75%	60% (1,000,000 + (500,000*40%)) / 2,000,000

APRA may also consider to recalibrate the CCF for these Off-Balance Sheet Commitments to be between 10% and 20% to be more closely aligned to international standards.

c. *Interest Only treatments*

There are several new requirements around capture of Interest Only which will have a material impact on risk weights if incorrectly classified as Non-Standard.

RegCentric propose that APRA provide further clarification to industry in terms of what scenarios the 5 year limit will apply. For example, APRA has not defined whether the cumulation of 5 years would apply where a completely new loan facility is written with the borrower after the initial 5 year IO term; would this be captured as a continuation of an existing facility? To track this will be operationally challenging and intensive for industry.

In addition, the proposed APS 112 does not provide guidance around the treatment of Equity Lines of Credit facilities or bridging loans (the latter are generally very short term in nature). Could APRA please confirm whether such facilities will be included as Standard under the reviewed rules.

As outlined, the implementation and ongoing tracking of interest only treatments for operations and systems will be challenging. A further example is tracking *greater than five year loans* that move to principal and interest which are required to be tracked for a period of six months as performing. If a loan moves to past-due status in that six-month period, can APRA confirm that the six-month period recommences from when the customer is moved back to performing status? If the loan is refinanced or a new loan application with the same borrower is approved during this period, will it be excluded from this requirement?

RegCentric proposes that the tracking of Interest Only requirements are grandfathered to new loans that are originated post 1st January 2023 to allow industry time to develop and implement systems and processes to capture the proposed rules accurately from this date. The requirements are onerous on ADIs and may result in inaccurate reporting and classifications and APRA may consider removing this requirement altogether.

d. Serviceability Criteria

Paragraph 5 of Attachment A refers to assessing the serviceability of a borrower at origination of a loan. APRA outlined for the purpose of this assessment that APRA may vary or apply additional serviceability criteria. Any changes or additional criteria imposed by APRA would require lead time to assess, build and implement into current processes across ADIs. Is APRA able to provide further details on what those additional criteria may be?

Paragraph 22 of Attachment A outlines the requirement that a loan, initially classified as non-standard at origination based on serviceability, must be performing consecutively for the previous 36 months before being treated as a standard loan. Is APRA able to confirm that, if a borrower refinances or provides a new loan application during this period and they meet the requirements of paragraph 5, they can be treated as standard?

RegCentric believe that the inclusion of the serviceability criteria is adding complexity to the capital framework due to the uncertainty around its application and the potential for inconsistent application of the additional serviceability criteria. We recommend that APRA provide further guidance on the circumstances where a loan will be considered standard vs non-standard and how this will be assessed.

We also note that the standard vs non-standard classification will need to be assessed across the three property exposures of residential; commercial property and land acquisition, development and construction. There are material differences in the risk weights that apply between standard vs non-standard, highlighting the requirement for industry to be provided with clear guidelines on how this will be assessed so that they can ensure policies; operational processes and data capture are setup correctly to adhere to these requirements.

We recommend that APRA provide further clarity to industry on how they will assess adherence to the requirements of Attachment A paragraph 3 to 7 in order for a loan to be classified as a Standard loan.

e. FX Exposures Multiplier and Capital

Small ADIs that apply standardised capital treatment generally have very small foreign exchange exposures by their very nature. That is, their borrowers are Australian domiciled and the contracts are denominated in AUD in terms of lending and servicing the loan in the same currency. It is therefore likely that any FX exposure of a small ADI is likely to be immaterial in comparison to the size and risk of the balance sheet exposures of that ADI. RegCentric consider limiting the capital impact to small ADIs in that APRA set limits on the size of the FX exposure in comparison to the size of the balance sheet before the ADI is required hold capital. This would allow small ADIs' ability to hedge non-AUD denominated contracts, and provide more options for managing the risk associated with foreign payments, without needing to work through the complexity of APS 116 requirements (particularly where the FX exposure in a number of cases may only be FX denominated service provider contracts that the ADI may want to hedge to reduce risk).

f. Residential Property

Paragraph 14(a) of Attachment A refers to the definition of "Owner Occupied" and the EFS concept of predominant purpose for which it provides three examples. "(e.g. owner occupied, investment and non-housing purpose)". Under EFS a non-housing purpose may include finance used for both personal or business purposes however in the definition of "Other" (paragraph 14(c)) reference is only made to "investment or business purposes". Can you please clarify how non-housing loans for personal purposes should be treated?

g. Consistency used of Definitions with EFS Framework

The revised APS 112 introduces a number of new data points, for example SME Retail and SME Corporate. The classification of corporate counterparty exposures using the definitions of SME Corporate and SME retail differ from those currently used to classify business counterparties as part of EFS collections. RegCentric propose that APRA consider the definitions for the proposed Standardised Asset Classes in APS 112 align with the EFS standards (or vice versa).

We thank APRA for the opportunity to lodge this submission and would welcome further discussion on our feedback. Please don't hesitate to contact us via email on info@regcentric.com.

Yours Faithfully

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