RESPONSE TO SUBMISSIONS

Finalising Bank Capital Guidance

July 2022

Disclaimer Text

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Executive summary

In November 2021, following multiple rounds of consultation with industry, APRA released final prudential standards for bank capital as part of a comprehensive reform of the framework.

The new capital framework aims to strengthen the financial resilience of the banking industry by embedding the industry's unquestionably strong levels of capital, with higher capital buffers providing greater flexibility for periods of stress. The relevant standards will become effective on 1 January 2023.[1]

APRA has now finalised and released the final Prudential Practice Guides (PPGs) alongside this *Response to submissions* paper. The PPGs provide guidance on sound practice for ADIs in implementing the revised standards, including the use of capital buffers and determination of credit risk capital requirements under the new framework.

The updated PPGs are:

- *Prudential Practice Guide APG 110 Capital Adequacy* (APG 110);
- *Prudential Practice Guide APG 112 Capital Adequacy: Standardised Approach to Credit Risk* (APG 112); and
- *Prudential Practice Guide APG 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APG 113).

APRA has also updated and released *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit* Risk (APS 113) with minor amendments resulting from the consultation on the guidance.

This paper:

- outlines APRA's response to issues raised by industry and other stakeholders in the consultation on the draft PPGs;
- initiates a consultation on consequential amendments to other relevant ADI prudential standards arising from the capital reforms; and
- outlines the next steps for implementation of the revised capital standards, including the use of temporary data proxies.

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[1] APRA's ADI capital reforms have covered the following prudential standards: *Prudential Standard APS 110 Capital Adequacy* (APS 110), *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit* Risk (APS 112), and *Prudential Standard APS 113 Capital Adequacy: Internal Rating-based Approach to Credit Risk* (APS 113). Updates to other relevant prudential standards for capital will be prioritised over the period ahead, including the market risk standards.

Glossary

ADI	Authorised deposit-taking institution
AIRB	Advanced IRB approach
APRA	Australian Prudential Regulation Authority
APS 001	*Prudential Standard APS 001 Definitions*
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 120	*Prudential Standard APS 120 Securitisation*
APS 180	*Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk*
APS 210	*Prudential Standard APS 210 Liquidity*
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
CCF	Credit conversion factor
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

LVR	Loan-to-valuation ratio
Net stable funding ratio (NSFR)	A ratio that measures a bank's amount of available stable funding relative to its required stable funding.
PD	Probability of default
RBNZ	Reserve Bank of New Zealand
RWA	Risk-weighted assets
SFI	Significant financial institution, as defined in APS 001.
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 - Overview

APRA finalised the ADI capital framework in November 2021, and is now focused on implementation ahead of the standards becoming effective from 1 January 2023. This chapter sets out the approach to finalising guidance, consultation on consequential amendments, and next steps for ADIs to implement the reforms.

Further information on the objectives and key features of the new ADI capital framework is provided in APRA's *Information Paper: An Unquestionably Strong Framework for Bank Capital* (November 2021).[2]

Finalised guidance

Alongside the finalisation of the ADI capital framework in November 2021, APRA released three draft PPGs for consultation: APG 110, APG 112 and APG 113. APRA received five submissions from ADIs and industry associations on the draft PPGs. Non-confidential submissions have been published on APRA's website.

APRA has undertaken extensive consultation with industry in finalising the PPGs, including bilateral meetings with ADIs and workshop discussions with industry associations. There are several areas where APRA has accommodated industry feedback to ensure the standards can be implemented practically, allow transition for new requirements, and fine-tune the calibration. In particular, APRA has revised its guidance on capital management targets and regulatory capital buffers, the treatment of residential property-backed guarantees, the definition of income-producing real estate, and loss given default for infrastructure assets.

In line with the strategic initiative to *modernise the prudential architecture*, APRA has also streamlined and simplified the supplementary advice that supports the capital standards. The final PPGs consolidate and replace other previously published advice, including six industry letters and four frequently asked questions (FAQs), which are listed in Annex A to this paper.

The final PPGs have been released alongside this paper, and feedback on the material issues raised in consultation has been provided in Chapter 2 of this paper. Based on feedback provided during the consultation process for the PPGs, APRA has also amended APS 113 to clarify issues that have been raised during the consultation on the guidance. The updated APS 113 has also been released alongside this paper.

[2] This response paper is available at: Revisions to the capital framework for authorised deposit-taking institutions | APRA.

Consultation on consequential amendments

To ensure APRA's broader prudential framework is consistent with the ADI capital reforms when they come into effect on 1 January 2023, APRA is undertaking a short consultation on consequential amendments to certain related prudential standards.

The consequential amendments relate to the treatment of exposures to New Zealand and the net stable funding ratio requirement in *Prudential Standard APS 120 Securitisation* (APS 120), *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180), and *Prudential Standard APS 210 Liquidity* (APS 210). More information on these issues is provided in Chapter 3 of this paper. The consultation on consequential amendments will be open until 26 August 2022 for comments. Other minor consequential amendments are planned for the third quarter of 2022, relating mainly to cross referencing in the ADI prudential framework.

Next steps

A timeline for the ADI capital reforms is provided below, covering the finalisation of the PPGs, consequential amendments and attestation.

Figure 1. Timeline of the reforms

APRA is additionally progressing a number of related reforms in this period. A proposed update to public disclosure requirements (*Prudential Standard APS 330 Public Disclosure*) is currently under consultation, with the aim to finalise the revised standard by the end of the year.[3] APRA is also examining the recent volatility in the interest rate risk in the banking book (IRRBB) capital requirement and will be consulting on technical aspects of these requirements later this year, as part of finalising *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*.

The key implementation steps for ADIs are:

- PCRs and ICAAPs: APRA will provide confirmation of updated entity-specific Prudential Capital Requirements (PCRs) to ADIs during the third quarter or early fourth quarter this year. Prior to 1 January 2023, APRA expects ADIs to continue with their Internal Capital

[3] Refer to: Public disclosure requirements for authorised deposit-taking institutions | APRA

Adequacy Assessment Process (ICAAP), considering the revised capital standards and updated guidance on a best endeavours basis.

- **Attestation:** As outlined in the June 2021 letter to industry,[4] APRA expects an accountable person from each ADI to attest by December 2022 that their ADI will be compliant with the ADI capital framework. The form and underlying evidence for the attestation will be up to each individual ADI. If there are issues with implementation in accordance with the required timelines, an appropriate approach to dealing with the issues would be expected to be agreed with APRA in advance of this attestation.

- **Reporting:** APRA is in the process of finalising the ADI capital reporting standards ahead of the first parallel run for the reporting period ending 30 September 2022. Further information on APRA's expectations for the parallel run is provided in APRA's April 2022 letter to industry.[5] APRA's updated reporting standards will be effective for the reporting period ending 31 March 2023.[6]

- **Use of temporary data proxies:** Implementation of the ADI capital framework may include temporary data proxies for unavailable data elements. APRA expects that any proxies would be temporary and in place for no more than twelve months after the implementation of the new framework. In line with the consultation letter on the ADI capital reporting standards,[7] proxies used in the parallel run should be reported to APRA, including the size of the impacted portfolio. APRA will engage more closely with IRB ADIs, and other ADIs where APRA deems necessary, on the appropriate usage of proxies. More information on the use of temporary proxies is provided in Chapter 4 of this paper.

ADIs that have any questions on the final PPGs or seek to provide feedback on the consultation on consequential amendments to the prudential framework, should contact ADIPolicy@apra.gov.au and copy in their supervision team. APRA will also continue to engage with ADIs on the implementation of the ADI capital framework more broadly, both bilaterally and through scheduled workshops coordinated by relevant industry associations.

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[4] Refer to: ADI capital reforms: Roadmap to 2023 | APRA.

[5] Refer to: Revisions to the ADI capital framework: Interim reporting standards for consultation and parallel run expectations | APRA.

[6] These reporting standards include: *Reporting Standard ARS 110.0 Capital Adequacy*, *Reporting Standard ARS 112.0 Capital Adequacy: Standardised Approach to Credit Risk*, and *Reporting Standard ARS 113.0 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*. ADIs that are required to report under the new *Reporting Standard ARS 115.0 Capital Adequacy: Standardised Measurement Approach to Operational Risk* will also be expected to lodge their first return for this collection 35 calendar days after March quarter end.

[7] Refer to: Revisions to the ADI capital framework: Interim reporting standards for consultation and parallel run expectations | APRA.

Chapter 2 - Finalising guidance

This chapter outlines the issues raised in APRA's consultation on the draft PPGs and APRA's responses.

Capital management targets and regulatory buffers (APG 110)

The draft APG 110 sets out an expectation that a prudent ADI would ensure it maintains an adequate management target above the top of regulatory capital buffers in stable operating conditions, to allow for business growth, volatility in risk-weighted assets (RWA), profit and capital surplus, and dividend policy. The management target would also be sufficient to withstand a severe but plausible downturn while remaining above the ADI's PCR.

Comments received

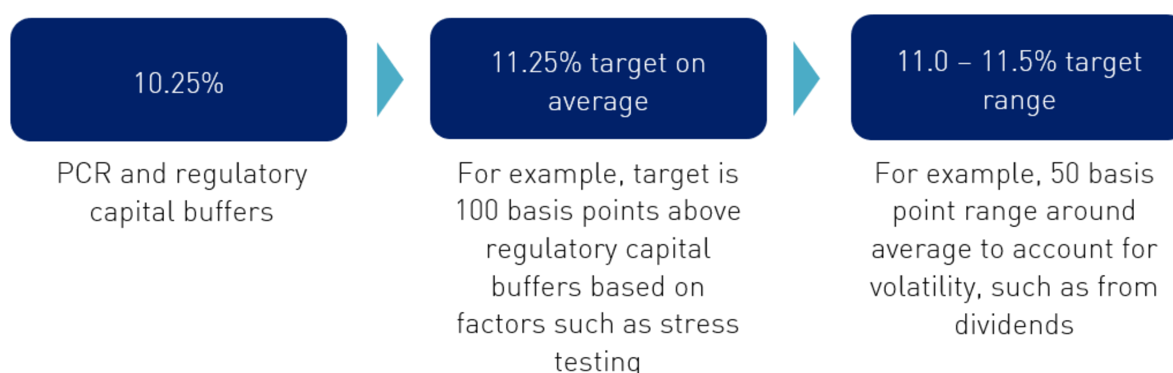
Some ADIs have sought greater clarity on APRA's expectations around the usability of capital buffers, including whether an ADI should hold a buffer above its management target in order to minimise the probability that it would fall below its target.

APRA's response

APRA has further clarified how it views management targets in the final APG 110. APRA does not consider an ADI's management target in the same manner as a regulatory minimum or buffer. For example, no constraints on distributions are placed on an ADI for falling below its management target range, unlike if its capital ratio entered a regulatory capital buffer.

In the example below (based on an ADI deemed to be a D-SIB), which is also included in the final APG 110, the ADI operates with a management target range of 11.0 - 11.5 per cent based on its average target level of 100 basis points above its PCR and regulatory capital buffers. APRA would not expect this ADI to set another buffer on top of the average target level of 11.25 per cent to avoid falling below it.

Figure 2. Example of setting a management target at a D-SIB



The capital framework is designed to ensure that an ADI can absorb the impact of losses and continue to lend during periods of stress. Operating within the regulatory capital buffer range is not a breach of prudential requirements, although constraints on profits distributions may come into effect. Issues around the usability of buffers continue to be considered

internationally at the Basel Committee, and APRA will continue to engage with overseas regulators as part of this process to ensure the approach in Australia is consistent with international practice.

Property-backed guarantees (APG 112)

Consistent with the Basel Committee on Banking Supervision's standards, APS 112 restricts ADIs from using credit risk mitigation (CRM) techniques in the calculation of the loan-to-valuation ratio (LVR) and applicable risk weight for an exposure.[8]

Comments received

Some ADIs noted that it is current market practice to include property-backed guarantees in the LVR calculation for loans secured by residential property. This normally occurs where a business owner secures a business loan by guaranteeing their residential property as collateral, or where an individual guarantees their property to help a family member attain a mortgage. Respondents requested to be allowed to include property-backed guarantees within the LVR calculation.

APRA's response

APRA has clarified in the final APG 112 (paragraph 19) that the restrictions on CRM techniques in APS 112 do not apply in these circumstances, and has included guidance that allows ADIs to include property-backed guarantees in their LVR calculations under certain circumstances. Where a loan is secured by multiple properties, an ADI may use the aggregate value of the mortgaged properties for the purposes of calculating LVR. However, an ADI may only include the value of property-backed guarantees in the aggregate value of the mortgaged properties if the rights to the property would be the same as a standard mortgage in the event of a default.

Small and medium enterprise definition (APG 112, APG 113)

Under APS 112, an exposure to an SME is an exposure to a corporate counterparty with total consolidated annual revenue of less than $75 million. This is similar to the approach taken under APS 113 (along with some additional restrictions).

Comments received

Some respondents requested further guidance on determining consolidated annual revenue, including querying whether the $75 million revenue threshold for general corporate SME under APS 112 was based on origination revenue or ongoing revenue, and whether this was the same as under the IRB approach.

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[8] Refer to: Basel III: Finalising post-crisis reforms (bis.org).

APRA's response

After considering the feedback received by respondents in the consultation process, APRA has provided further clarity in the final APG 112 (paragraph 34) and the final APG 113 (paragraph 23) on how the revenue threshold is calculated in different circumstances.

Where the exposure is **greater** than or equal to $5 million, an ADI is expected to use revenue that is updated on an ongoing basis after origination for determining SME eligibility. The revenue would be based on the average amount calculated over the prior three years or the latest amount updated at least every three years. This applies under both APS 112 and APS 113.

Where the exposure is **less** than $5 million, an ADI would typically use revenue data at the time of origination or refinancing for the purpose of asset classification. Better practice would be to update the revenue data on an ongoing basis; however, this is not a requirement. An ADI may use sources other than financial statements for the purpose of determining revenue. This is also consistent with APS 220. APRA recognises that there might be limited circumstances in which revenue data is not available. On an exceptions basis, where an ADI is otherwise satisfied that the exposure to a corporate counterparty or a corporate group has total consolidated annual revenue of less than $75 million (and the exposure is less than $5 million), the following treatment may be used:

1. under APS 112, where no revenue data (from financial statements or other sources) is available at origination or refinancing, an ADI may treat the exposure as SME in accordance with paragraph 22 of Attachment B to APS 112. Further, where the exposure is less than $1.5 million, an ADI may treat the exposure as SME Retail in accordance with paragraph 24 of the same attachment; and

2. under APS 113, where no revenue data (from financial statements or other sources) is available at origination or refinancing, an ADI may apply the minimum values set out in paragraph 7 of Attachment A to APS 113 for determining the SME eligibility. An SME exposure may be classified as SME Retail provided that other criteria set out in paragraph 40 of APS 113 (e.g. exposure is less than $1.5 million, non-complex, etc) are met.

APRA considers it appropriate for ADIs to, at a minimum, obtain revenue data when undertaking a serviceability assessment, given revenue is a major factor in determining ability to repay debt.

Definition of income-producing real estate (APS 113, APG 113)

The draft APG 113 provided guidance on when an exposure to an individual borrower, trust or family company would typically be classified as income-producing real estate (IPRE), including if it meets the criteria that a borrower has mortgaged five or more housing units (excluding the borrower's primary residence) with the ADI or other lenders. This information would be obtained at origination and updated on a best endeavours basis.

Comments received

Some respondents noted that customers with five or more investment properties may not have originated all loans with the same ADI, making it difficult for an ADI to obtain data to meet the criteria on an ongoing basis after origination. Additionally, although respondents acknowledged these borrowers posed additional risk relative to the average retail borrower, adjusting operational processes to treat these clients as 'non-retail' exposures would not necessarily deliver the optimal risk and customer outcomes in all cases.

Respondents instead suggested that individuals with five or more investment properties should either:

1. remain in the residential property asset class but have a higher scalar applied to the RWA of these exposures under APS 113; or

2. treat these exposures as IPRE for regulatory capital purposes, but continue to manage these borrowers as retail in terms of model use and customer management.

APRA's response

APRA notes the difficulty in obtaining and updating information on a borrower's properties, given they may originate loans at multiple ADIs. Therefore, APRA has limited the guidance for an ADI to obtain data on the number of properties owned by an individual to 'at origination or refinancing'.

In addition, given this cohort of borrowers has different risk profiles compared to retail borrowers with less than five investment properties, APRA has amended APS 113 (Attachment A, paragraph 14) to include a 2.5 scalar for this asset class to ensure capital requirements are commensurate with their risk profile.

In identifying borrowers with five or more investment properties, APRA has provided guidance in APG 113 that properties mortgaged with the ADI and other lenders should be considered in the count of properties. However, for exposures originated or refinanced before 1 January 2023, it may be reasonable to conclude that a 2.5 scalar does not apply where the ADI checks that the borrower has less than five mortgaged properties with the ADI and does not have any other information to suggest that the borrower has five or more mortgaged properties overall.

APRA has also provided guidance in the final APG 113 (paragraph 29) that an ADI would have effective criteria in place to identify and monitor retail borrowers with multiple investment properties, and have effective criteria in place to identify and monitor them as corporate where appropriate.

Loss given default for infrastructure assets (APS 113, APG 113)

Consistent with the Basel framework, APS 113 restricts ADIs from modelling loss given defaults (LGDs) for large corporate exposures, which include exposures to operators of large public infrastructure assets. ADIs instead use the prescribed estimates under the foundation IRB approach.

Comments received

Some respondents noted that, compared to the current requirement, the prescribed LGDs and eligibility criteria will result in a significant increase in the capital required for exposures to operators of large public infrastructure assets. ADIs requested these exposures be included in the 'Other eligible physical collateral' category.

APRA's response

APRA agrees that the prescribed LGD is not commensurate with the level of risk present. To ensure that Australian ADIs can continue to support the development of domestic public infrastructures and an appropriate capital requirement is applied, APRA has amended APS 113 (Attachment B, paragraphs 10 and 12). The FIRB LGD applicable to exposures to operators of large domestic public infrastructure assets that are not secured by eligible collateral has been lowered to 25 per cent. Similar exposures deemed unsecured under the AIRB approach will also be assigned a 25 per cent LGD instead of 50 per cent. APRA's view remains that concessions or the right to operate are not physical collateral.

Other changes to the PPGs

APRA has also made a number of other less material changes to APG 110, APG 112, and APG 113, to incorporate feedback from submissions. These changes have been summarised in the tables below.

Table 1. Key changes to APG 110

Issues	Comments received	APRA response
Capital distributions	For which period are earnings used to determine constraints on distributable profits (i.e. on a retrospective or prospective basis)?	APRA has clarified in APG 110 that the current (i.e. retrospective) approach continues to apply.
Simplified requirements	Given APRA's proposed changes to the significant financial institution (SFI) definition, could the guidance in APG 110 be updated?[9]	APRA has updated APG 110 in line with the final changes.

Table 2. Key changes to APG 112

Issues	Comments received	APRA response
Mortgages over a lease of crown land	How would an ADI treat a mortgage over a lease of crown land?	APRA has clarified in APG 112 that mortgages over leases of crown land can be treated as standard property exposures and categorised depending on the type of property used as collateral.

[9] Refer to: Consultation on minor amendments to centralise the definition of a significant financial institution | APRA.

Issues	Comments received	APRA response
Duplex residential properties	How should a loan secured against a not-yet-completed duplex residential property be classified under APS 112 if the borrower is going to live in one duplex and rent out the other?	APRA has updated APG 112 to clarify that APRA considers it would be reasonable for an ADI to treat an incomplete duplex residential property in which the borrower is intending to occupy one duplex and rent the other duplex for income as an owner-occupied standard loan.
Exposures with currency mismatch	Does the hedge test apply to an exposure at origination or does an ADI need to apply the test on an ongoing basis?	APRA has updated APG 112 to clarify its expectations that the hedge test would generally apply at origination and during any subsequent serviceability assessments.
Eligible financial collateral	Is it appropriate to consider covered bonds provided as collateral as representing eligible financial collateral under APS 112?	Covered bonds are one form of debt security that meet the definition of eligible financial collateral under APS 112. As such, covered bonds provided as collateral may be classified as eligible financial collateral with a 0 per cent LGD as per Table 7 in APS 113. APRA has included guidance on this in APG 112.

Table 3. Key changes to APG 113

Issues	Comments received	APRA response
Credit risk mitigation (CRM) – definition of comparable direct exposure	APS 113 does not permit the application of CRM to result in an adjusted risk-weight that is less than a comparable direct exposure to the guarantor or credit protection provider. For the purpose of calculating the risk-weight of a comparable direct exposure, can collateral offered by the borrower be recognised in the LGD?	Collateral provided by the borrower cannot be recognised in the risk-weight calculation for a comparable direct exposure to a guarantor or credit protection provider. Consistent with the intent of the Basel framework, a comparable direct exposure is an unsecured claim to the guarantor or credit protection provider. However, APRA has clarified in APG 113 that, if the guarantor or credit protection provider pledges collateral, this collateral may be reflected in the risk-weight of a comparable direct exposure.
Constraining factors in the calculation of EAD	APS 113 (Attachment B, paragraph 33) permits an ADI to apply credit conversion factors (CCFs) to the lower of the value of the unused committed credit line and the value of any other constraining factor. Can	APRA has included additional guidance on constraining factors in APG 113. For a constraining factor to be recognised, it would be written explicitly into the facility documentation and processes would

Issues	Comments received	APRA response
	APRA provide examples of constraining factors?	exist to check adherence to the constraint prior to approving drawdowns. Conditions precedent generally would not be recognised as constraining factors. Exposures that are drawn in stages according to a pre-arranged schedule (such as construction loans) would also be excluded from such treatment. APRA has also clarified in APS 113 that this requirement in Attachment B paragraph 33 is not applicable to retail exposures.
Consolidated annual revenue	For the purpose of determining the consolidated annual revenue of a group of connected borrowers, can an ADI only consider borrowers within a group to which it has recourse?	APRA has clarified in APG 113 that, to determine consolidated annual revenue, an ADI would sum the revenue of all entities in a connected borrower group to which it has recourse. Transactions between entities in the group may be netted off for this purpose.
Public sector entities	Can APRA provide guidance on determining consolidated annual revenue for public sector entities?	APRA has clarified in APG 113 that public sector entities without specific revenue raising powers (e.g. agencies, statutory authorities and bodies created to enable legislation) may be assigned the minimum revenue amount in APS 113 (i.e. $7.5 million) for asset classification and risk-weighting purposes. For all other public sector entities, the reported consolidated revenue amount would be used.
Land acquisition, development and construction (ADC)	Does APRA intend for ADC exposures to be considered a subset of IPRE under APS 113?	The differences in the definition of ADC exposures in APS 112 and IPRE in APS 113 are intended, as this reflects the treatment under the Basel framework. APRA has updated the mapping table in APG 113 to clarify that not all ADC exposures would be treated as IPRE.
FIRB LGD calculation	How is 'E' defined for the purpose of the LGD calculation under the FIRB approach in APS 113 (Attachment B paragraph 16)?	'E' is the committed amount. In the case of SFTs, 'E' is cash lent or securities lent or posted and 'E' must be increased by applying the appropriate haircuts (H_E) according to the comprehensive approach for the recognition of financial collateral as detailed in Attachment G to APS 112.

Issues	Comments received	APRA response
		APRA has amended APS 113 to reflect the policy intention.
LGD for covered bond exposures	What LGD is applicable to covered bond exposures?	APRA has clarified in APG 113 that, for covered bond exposures, an ADI would apply the FIRB LGD for eligible residential or commercial real estate.
Default rate calculation	In the default rate calculation, will APRA allow the use of 'half of all exits' where an ADI cannot accurately identify refinancing or matured facilities within a portfolio?	APRA has retained the current approach to incentivise better data capture. The use of half of all exits in the default rate calculation is not permitted.
Multiple defaults	Can APRA provide additional guidance on the treatment of multiple defaults for estimation purposes?	APRA has clarified in APG 113 that, where there are multiple defaults of a given facility or borrower, a prudent ADI would treat the facility or borrower as being continuously in default for PD, LGD and EAD estimation purposes if the time between the end of one default (i.e. return to performing) and the start of a subsequent default is less than nine months. A longer period may be used if it is appropriate to the type of exposure.

Chapter 3 - Consequential amendments

APRA is consulting on, and welcomes feedback on, the following two proposals for consequential amendments by 26 August 2022, including any assessment of the likely impact of these changes. These amendments would apply from 1 January 2023.

Residential Mortgage Risk Weights and the Net Stable Funding Ratio

The capital reforms include changes to the risk weights for residential mortgages in APS 112. These changes have a flow-on impact on the net stable funding ratio (NSFR) in APS 210, which uses the mortgage risk weights to assign the level of Required Stable Funding (RSF) for mortgages. A consequence of the changes from the capital reforms is that fewer mortgages would be eligible for an RSF factor of 65% in calculating the NSFR.

APRA proposes to amend APS 210 to reduce this unintended impact. Previous submissions from ADIs and discussions at bilateral meetings with ADIs have supported an adjustment to the NSFR requirements. The proposed change to APS 210 is to replace paragraphs 35(a) and 36(b) of Attachment C with:

> 35. An ADI must assign a 65 per cent RSF factor to the following assets:
>
> a) unencumbered standard residential property loans to an individual (that is, a natural person) or individuals, with a residual maturity of one year or more and a loan-to-valuation ratio of 80 per cent or below, as defined under APS 112.
>
> 36. An ADI must assign an 85 per cent RSF factor to the following assets:
>
> b) other unencumbered performing loans that do not qualify under paragraph 35 of this Attachment that have residual maturities of one year or more, excluding loans to financial institutions;[27]
>
> Footnote 27: Whether a loan is performing or non-performing is determined by reference to *Prudential Standard APS 220 Credit Risk Management*.

Residential property exposures not to individuals may still be eligible for a 65 per cent RSF factor under paragraph 35(b) of Attachment C, where the exposure has a 35 per cent or lower risk weight.

Treatment of New Zealand Exposures

APS 112 and APS 113 allow ADIs to use equivalent requirements set by the Reserve Bank of New Zealand (RBNZ) to calculate credit RWA, instead of APRA's requirements, subject to certain exceptions (refer to paragraph 13 of APS 112 and paragraph 13 of APS 113). APRA's *Response to Submissions: Finalising the Bank Capital Reforms (November 2021)* clarified that New Zealand overseas banking subsidiaries would also apply the RBNZ's equivalent

prudential rules for measuring counterparty credit risk exposures for the purpose of the credit risk RWA calculations under APS 112 and APS 113.[10] As part of its response, APRA indicated that it would consider whether further simplification was required in other parts of the framework when determining consequential amendments.

Application to APS 180 and APS 120

After further consultation, APRA proposes to also apply a similar treatment of New Zealand exposures under both APS 180 and APS 120 to enable a clear, consistent, and simple approach to the treatment of New Zealand exposures across the prudential framework.

The proposed change to APS 180 is the addition of the following subparagraph at the end of paragraph 10 of APS 180:

> 10. An ADI must apply the counterparty credit risk requirements:
>
> f) for the purpose of calculating the Level 2 Regulatory Capital requirement for the credit exposures of an overseas banking subsidiary that is prudentially regulated by a prescribed New Zealand authority, an ADI must calculate RWA using the prescribed New Zealand authority's equivalent prudential rules as in force from time to time.[3]
>
> Footnote 3: *prescribed New Zealand authority* has the meaning given in subsection 5(1) of the Banking Act.

The proposed change to APS 120 is to insert the following paragraph after paragraph 10 of APS 120:

> 11. For the purpose of calculating the Level 2 Regulatory Capital requirement for the credit exposures of an overseas banking subsidiary that is prudentially regulated by a prescribed New Zealand authority, an ADI must calculate RWA using the prescribed New Zealand authority's equivalent prudential rules as in force from time to time.[1] An ADI must still make deductions from Common Equity Tier 1 Capital that are required to be deducted by this Prudential Standard.
>
> Footnote 1: *prescribed New Zealand authority* has the meaning given in subsection 5(1) of the Banking Act.

Request for submissions

APRA invites written submissions on the consequential amendments to APS 120, APS 180 and APS 210. Written submissions should be sent to ADIpolicy@apra.gov.au by **26 August 2022** and addressed to the General Manager, Policy, APRA.

[10] Refer to: Revisions to the capital framework for authorised deposit-taking institutions | 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.

Chapter 4 - Implementation and data

As part of a pragmatic implementation of the ADI capital framework, APRA is open to the use of temporary proxies where data to calculate capital requirements in accordance with the prudential standards is unavailable. For this purpose, proxies are values or treatments that seek to approximate or replace the data required by the relevant prudential standard.

The capital ratio needs to be a reliable and accurate measure of the ADI's capital position. In determining a suitable proxy, it is important to consider the likely margin of error of the proxy. Where there is a greater margin of error, APRA expects a more conservative treatment would be applied. A prudent ADI would also have appropriate controls and governance around the usage of these proxies.

APRA expects that proxies would be temporary and in place for no more than twelve months after the implementation of the new framework. Exceptions may be allowed where the proxy applies to an immaterial part of the ADI's portfolio and/or long-dated back book exposures.

Data proxies requiring approval

APRA has developed a tiered approach to proxies used by IRB ADIs, and other ADIs that have been notified by APRA. These ADIs should seek APRA's approval prior to the use of material proxies, which are proxies that apply to more than one per cent of an ADI's exposures at default (EAD) or credit RWA. APRA expects these ADIs to provide the remaining proxies during the September 2022 parallel run process or at the earliest opportunity thereafter if the need for further proxies is identified.[11] APRA considers that the use of a capital overlay to resolve data unavailability would be considered a proxy for this process.

Table 4. Proxy tiers and submission dates

Proxy type	Description	Submission date
Material proxies	Proxies that apply to more than 5% of EAD or credit RWA	1 August 2022
	Proxies that apply to between 1% and 5% of EAD or credit RWA	1 September 2022
Remaining proxies	Proxies that apply to less than 1% of EAD or credit RWA	25 November 2022 (alongside parallel run submission)

APRA encourages submissions from all ADIs on material proxies as soon as practicable, noting the dates above represent the last dates for submissions in each period.

[11] This is in line with the expectations communicated to industry in APRA's April 2022 letter, *Revisions to the ADI capital framework: interim reporting standards for consultation and parallel run expectations*.

Other ADIs not included in this cohort are only expected to submit information alongside the parallel run submission. However, it would be prudent for an ADI to consult with APRA where it anticipates that it might require the use of a material proxy, either in quantity or quality. APRA may engage with ADIs on their submitted proxies after assessing the parallel run submissions.

Data proxy submission requirements

APRA is seeking (at a minimum) the following information for material proxy submissions:

- a description of why the proxy is required;
- whether the proxy will be used for calculating capital on an IRB or standardised basis;
- how the ADI will remediate the issue(s) that led to the need for the proxy;
- proxy methodology (including rationale) with any margin of conservatism clearly highlighted;
- how long the proxy is expected to be in use;
- the proportion of the portfolio impacted; and
- an estimate of the margin of error (both in terms of the value of the data element and RWA) between the proposed proxy and the likely 'true' value on a best endeavours basis. Sensitivity testing based on a range of values is also permissible.

For the remaining proxies, ADIs may include a brief description of the methodology, the proportion of the portfolio impacted and how long the proxy is expected to be in use.

Proxies will be approved on a case-by-case basis. Where later approvals have implications for consistency across the industry, APRA may require a capital overlay to be added.

Where ADIs wish to submit data proxies for approval, submissions should be directed to their supervision team and copy in ADIPolicy@apra.gov.au. For any questions on the proxy process, please contact ADIPolicy@apra.gov.au.

Annex A - Superseded APRA advice

The final standards and PPGs have consolidated and replaced previously published APRA guidance and advice, including the following industry letters and FAQs.

Table 5. List of superseded APRA industry letters and FAQs

Letters to ADIs	
October 2009	Identification of IPRE specialised lending exposures
July 2010	Basel II: Treatment of reverse mortgages and shared equity mortgages
January 2013	Treatments of loans to self-managed superannuation funds
January 2014	Clarification or IRB regulatory capital and reporting requirements
July 2015	APRA increases capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach
December 2015	Internal Ratings-based (IRB) Approach to Credit Risk: Accreditation Process[12]
FAQs	
December 2020	What are APRA's expectations when measuring realised economic loss, prior to collection costs, for loss given default (LGD) estimation?
March 2021	What are APRA's expectations for revaluing residential properties, for the purpose of measuring capital requirements under the standardised approach?
June 2022	What is the appropriate credit conversion factor to be used in determining the regulatory capital of insurance stand-by letters of credit?
July 2022	What is the prudential treatment of residential mortgage loans issued under the Home Guarantee Scheme?

[12] This excludes Attachment C to the letter, which will be covered by the upcoming revisions to *Prudential Standard CPS 230 Operational Risk Management*.

APRA