Australian Banking Association

26 August 2022

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Australian Prudential Regulation Authority

By email: Redacted

Dear Mr Redact,

Finalising Bank Capital Guidance

The Australian Banking Association (**ABA**) welcomes the Australian Prudential Regulation Authority's (**APRA**) ongoing engagement with industry regarding the development of the revised capital framework including the consequential amendments to Liquidity (**APS 210**), Securitisation (**APS 120**) and Counterparty Credit Risk (**APS 180)** and the release of the final Prudential Practice Guides (**PPGs**) for bank capital – APG 110, APG 112 and APG 113 – and the updated prudential standard, APS 113.

While the release of the finalised PPGs (and associated standards) marks a milestone in the development and implementation of the revised capital framework (Basel 3.5) considerable work remains over the coming years to: imbed the changes; develop and implement reporting capabilities; and educate industry observers, commentators and participants about the new capital and reporting requirements.

The ABA provides the attached comments for APRA's consideration which cover both the consequential amendments and the capital framework package more broadly.

The ABA and its members look forward to ongoing engagement with APRA on these important reforms. If you require further information or would like to discuss any of the content of this letter, please do not hesitate to contact me on Redacted or Redacted

Regards,

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Australian Banking Association

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

Appendix A: Consequential Amendments to the Prudential Standards

APS 210 Liquidity

The ABA welcome APRA's changes to APS 210 in response to changes in the credit risk capital standard APS 112. APRA's proposals remove the linkage of the mortgage Required Stable Funding (**RSF**) factors from the risk weights under APS 112, and instead base the determination on the LVR and maturity of each mortgage facility. The ABA notes that while the changes are more aligned to the existing liquidity framework, APRA has removed the reliance on LMI and government guarantees to determine the RSF factors.

- Under the current framework, a residential mortgage with LMI and an 80-90% LVR can still be assigned a 65% RSF factor. As recognised in the credit framework APS 112 and APS 113, LMI reduces the credit losses for a home loan and improves the ability of the loans to be securitised.
- In addition government backed loans, for example those that satisfy conditions for inclusion within the First Home Loan Deposit Scheme or the Family Home Guarantee Scheme, are also assigned a 65% RSF factor due to the value of the government guarantee.

The ABA recommends that APRA amend the proposed paragraph 35 to allow for the recognition of LMI and government guarantees, such that it reads:

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. Mortgages with an 80-90 per cent LVR ratio may also be recognised if at minimum 40% of the loan is insured by an acceptable LMI.

b) Unencumbered standard residential property loans, with a residual maturity of one year or more, that satisfy conditions for inclusion within the First Home Loan Deposit Scheme or the Family Home Guarantee Scheme, and in respect of which the National Housing Finance and Investment Corporation has issued a guarantee certification to the ADI. This treatment ceases to apply when the guarantee certificate expires or is released in accordance with the terms of the Deed of Guarantee in respect of the First Home Loan Deposit Scheme or the Family Home Guarantee Scheme or APRA determines that it no longer applies.

APS 120 Securitisation

For Securitisation Exposures in ARS 110; Section B; Part 1, APRA has excluded New Zealand subsidiary (**NZ**) securitisation exposures, along with NZ subsidiary Standardised and Advanced exposures in light of the proposed change to regulatory capital treatment of NZ securitisation exposures.

In view of this, the ABA recommends that consequential amendments be made to ARS 120 and APS 330 to exclude NZ securitisation exposures from ARS 120 (Level 2) and report NZ subsidiary exposures separately for Pillar 3.

APS 180 Counterparty Credit Risk

APRA has proposed the addition of the following wording at the end of Paragraph 10 in APS 180:

"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……."

The implication of this change to APS 180 is that ADIs would bifurcate to apply:

a) APRA rules to calculated credit default risk RWA, CVA Capital Charge, CCP exposure including trade exposure, collateral posted and default fund for non-NZ subsidiary derivative trades; and

b) RBNZ rules to calculated credit default risk RWA, CVA Capital Charge, CCP exposure including trade exposure, collateral posted and default fund for NZ subsidiary derivative trades.

ADIs are working to implement the required changes to apply respective APRA and RBNZ rules to credit default risk RWA as specified in APS 112. The consequential changes to apply RBNZ rules to other capital charges such as CVA Capital Charge, CCP exposure treatment including trade exposure, collateral posted and default fund for NZ subsidiary derivative trades are new requirements and require additional time and significant effort to implement.

Additionally, this adds significant complexity to reporting where relevant reporting standards and templates may need to be modified, which in turn requires additional time for system development to accommodate these changes. For example, the current ARS 180.2 reporting form assumes exposure is based on APRA rules only (such as SA CCR, CCP and default fund exposure), which would need to be revised to also accommodate RBNZ rules, which require CEM methodology for derivative exposures and different rules for CCP exposure such as default fund.

A further complication is that any future changes to either APRA or RBNZ rules will require system changes to calculation and reporting, resulting in more frequent system changes.

The ABA recommend the following:

- Removing RBNZ from ARF 180 consistent with their treatment in the ARF 112 and ARF 113 forms, whereby NZ is excluded in line with the prudential requirements.
- Allowing a pragmatic implementation approach for ADIs to adopt the consequential amendments to APS 180 from 1 January 2023.

APS 110 Leverage Ratio

APRA's requirements on the calculation of the leverage ratio exposures for the non-market-related off-balance sheet exposures *(APS 110 Attachment D-12)* are to be derived by applying the credit conversion factors (**CCFs**) based on APRA APS 112 CCFs to the gross notional amounts of off-balance sheet items and the calculation of the derivative exposures are to be based on APRA modified SA-CCR rules *(APS110 Attachment D 17-36)*.

The approach in the calculation of leverage ratio exposures under the revised APS110 for the non-market off-balance sheet and derivative exposures for NZ overseas banking subsidiary conflicts with the calculation of NZ subsidiary credit risk exposures under APS112/113/180/120 to be based on RBNZ rules.

To support a clear, consistent and simple approach to the treatment of NZ exposures across the prudential framework, the ABA is proposing to adopt the non-market off-balance sheet and the derivatives credit exposures as calculated under RBNZ rules for the purpose of the APS 110 leverage ratio exposures of the NZ subsidiary.

Appendix C: Final Prudential Practice Guide

Mortgage registration (paragraph 7, APS 112)

In regards, to paragraph 7 in APG 112:

> *7. A loan may still be categorised as standard if there is a timing mismatch between customer acceptance and mortgage registration, provided that mortgage registration, or associated controls, takes place before or concurrent with drawdown.*

Mortgage registration can only be performed post settlement and drawdown, after official transfer of property ownership occurs as part of the settlement process.

Prior to settlement, the property cannot be registered with the land registry by the buyer's financial institution, as:

- no funds have changed hands;
- the buyer (our customer) does not yet officially own the property (or in the case of a refinance, the incoming bank hasn't paid the discharging bank);
- the seller has not yet discharged their debt with their financial institution;
- the seller's financial institution still has a claim against the property to settle the debt in the event of default;
- the loan cannot be drawn down by the buyer (our customer) as no security has been provided; and
- no stamp duty has been paid by the buyer. Any outstanding council rates, emergency services levy and land tax have not yet been settled by the seller.

The ABA proposes allowing for a registration lag of 3-6 months for new loans and an ADI would rely on the associated controls prior to the finalisation of the registration process to consider these loans as 'Registered', This is proposed in order to:

- Take into account the time it takes land registries to process both Standard Dealings and Non-Standard Dealings (the latter including matters such as Caveat / Survivorship or Transmission (Deceased Estate forms) / Power of Sale) and paper-based applications.
- Allow for delays outside of banks' control, such as delays in provision of the registration information from various state land registries, which may be dependent on the time of year, for example, December/January holiday period or technology or personnel capacity issues, and other processing delays, including those created by customer and solicitor rework.
- Allow time for the FastRefi process to transfer security interest.
- The time it takes the bank to validate and input the returning data and make it available for reporting.
- Prevent artificial inflation of the Non-Standard segment for new loans, for which registration is only a matter of time

5 or More Properties (Paragraph 28, APG 113)

In draft APG 113 (dated November 2021), paragraph 23 contained the following provision:

> "*An exposure to an individual borrower, trust or family company would typically be classified as IPRE if it meets the following criteria*"…one of which was:
>
> "*prospects for debt servicing and repayment depend primarily on cash flows generated by real estate*".

In the final APG 113, this condition around reliance on property cash flows is removed. Under paragraph 28, it now simply requires:

> "…..an ADI to separately identify retail residential mortgage exposures to borrowers that have mortgaged five or more investment properties".

The ABA believes that this omission changes the nature of what APRA were intending to capture as part of the original '5 or more property rule' i.e. that customers in this segment have a higher concentration risk and risk of default during a stress event due to their material dependence on property i.e. rental income. In particular, many high-net worth individuals have extensive and varied income sources, of which property-related income is only one. Accordingly, they will not have a material reliance on that income source to meet their commitments. It follows that applying the 2.5x IPRE scalar to these exposures seems counter-intuitive.

The ABA would like to strongly recommend that APRA re-instates the earlier "depend primarily on cash flows generated by real estate" condition.

Counting of Properties (Paragraph 28, APG 113)

The ABA appreciates APRA's guidance on this point under paragraph 28 in APG 113. In respect of trust and company borrower arrangements, on a best endeavours basis, member banks intend to apply the provisions as follows:

<u>Trusts and Trustees</u>

As a trust is not a separate legal entity, the loan exposure (and our credit assessment) is recorded against the trustee. The trustee can be either an individual or a company. Where individuals and trusts can be linked, the industry's proposal is as follows:

For an individual person, treat the loan exposure to an individual trustee the same as a normal exposure for the same borrower (that is, where a property held in a trust is used as security for a loan, it would count as one mortgaged investment property for that borrower).

Example:

Scenario	Exposure	Property count	Scaling factor for risk weighting purposes
Individual A owns 2 investment properties and there are 3 other properties held in the ABC family trust with A as trustee	Exposures to borrower A	2+3=5	2.5
	Exposure to borrower A as trustee for Family ABC trust	2+3=5	2.5

<u>Companies</u>

For a company borrower (as a trustee or a non-trading company investing in properties), treat the exposure separately:

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Example:

Scenario	Exposure	Property count	Scaling factor for risk weighting purposes
Individual A owns 2 investment properties and there are 3 other properties held in the ABC family trust with company X as trustee	Exposures to borrower A	2	1.7
	Exposure to company X as trustee for ABC family trust	3	1.7

Comparable Direct Exposure (APG 113; Paragraph 56)

The ABA thanks APRA for listening to the industry on the “comparable direct exposure” issue. Industry now understand that where a group rating approach that complies with APS 113, Attachment D, Paragraph 44 has been applied, then PD uplift from the stronger parent and LGD based on collateral provided by an obligor is permitted due to the cross-collateralisation that underpins the group rating.

ADIs seek APRA’s confirmation of their understanding that this will not only apply where the underlying exposure is an asset finance transaction, which is used simply as an example in Paragraph 56 of APG 113.

Standard versus Non-Standard Loans (APS 112)

In APS 112, Attachment A, Paragraph 21, non-standard loans that are non-standard due to non-compliance with Paragraph 5 (unable to verify repayment capacity) revert to standard once the facility satisfies the condition of “performing consecutively for the previous 36 months”. This “cure” provision is specific for Residential Property (only):

> *“A loan **secured by residential property** which does not meet the criteria set out in paragraph 5 of this Attachment, and consequently must be classified as a non-standard loan, may be reclassified as a standard loan where the loan has been performing consecutively for the previous 36 months.”* (emphasis added)

However, in APG 112 this is discussed under Chapter 1 “Property Exposures” (that is, all property exposures):

“Non-standard loans

12. *A loan that does not meet the criteria for a standard loan would be classified as non-standard.*
13. *A non-standard loan that does not meet the serviceability criteria under APS 112 (Attachment A, paragraph 5) and has been performing consecutively for the previous 36-months may be subsequently reclassified as a standard loan. A ‘performing’ loan is a loan that does not meet the definition of ‘non-performing’ under APS 220.”*

While APS 112 Attachment A Paragraph 21 only applies to Residential property and the Prudential Standard has no comparable upgrade path for Commercial property, the ABA seeks APRA’s confirmation of its understanding that industry can indeed re-classify Commercial property exposures in the same way, in accordance with APG 113 Paragraph 13.

Standard versus Non-Standard Loans (Paragraphs 18 and 19, APS 112)

Industry seeks clarification from APRA on paragraphs 18 and 19, introduced by APRA in the final version of APG 112, on whether paragraphs 18 and 19 was intended for residential properties only, as

these two paragraphs were documented under the "Residential Property" heading, or are asset agnostic, for example, also be available for commercial properties.

The definition of 'E' (Paragraph 16, APS 113)

The ABA notes the calculation of the exposure weighted average of LGD specifies that "E is the committed amount." However, the term 'committed amount' has resulted in different interpretations between ADIs which also allows for deviation from international practices.

Industry seeks further clarification on how to apply the formula considering the on-balance sheet as well as the off-balance sheet component of an exposure and specifically whether this should be pre or post the application of a CCF. The following points are particularly relevant in considering clarification:

- 'E' is the measure of exposure used in the calculation of LGD, that LGD conceptually should represent the amount of loss should a default occur in the future. This should take into account the likelihood of drawdown of off-balance sheet exposure up to the date of default which is reflected in the CCF; and
- It was stated in the indicative views on guidance provided by APRA on 27 April 2022 that in the case of SFTs, 'E' is cash lent or securities lent or posted and 'E' must be increased by applying the appropriate haircuts (HE) according to the comprehensive approach for the recognition of financial collateral as detailed in APS 112 Attachment G.

In attachment G, the comprehensive approach states the following:

E' is $\Sigma_j E_j \times (1+H_{jA})$ where Ej is the ***EAD*** *of the j-th item of exposure or posted collateral under the transaction, prior to haircuts or adjustment for received collateral*

- In the BCBS' *Basel III: Finalising post-crisis reforms*, December 2017, paragraph 74 states the following: *E is the current value of the exposure (ie cash lent or securities lent or posted). In the case of securities lent or posted the exposure value has to be increased by applying the appropriate haircuts (HE) according to the comprehensive approach for financial collateral.*

In this comprehensive approach 'E' is referred to as:

  - *160. For a collateralised transaction, the exposure amount after risk mitigation is calculated as follows: E* = max {0, E.(1+He)-C.(1-Hc+Hfx)}*

where:

E = the exposure value after risk mitigation*

E = current value of the exposure

  - *162.The exposure amount after risk mitigation (E*) must be multiplied by the risk weight of the counterparty to obtain the risk-weighted asset amount for the collateralised transaction.*

The exposure amount 'E', or the current value of the exposure, must include a CCF applied to off balance sheet amounts/facilities, otherwise the calculation would result in an overstated risk-weighted asset amount.

The ABA proposes a clarification of the word "committed amount" and proposes the use of EAD, or on balance sheet committed amount + off balance sheet amount * CCF, in this formula to assure alignment across the framework and also within Australia between the ADI's and other international Banks.

Other Matters: Credit-modelling Related

- **Retail Non-Standard Property Exposures (Paragraphs 12 to 14, APG 112)**

Non-Standard Loans will now attract regulatory risk weights as prescribed under APS 112, and be removed from the IRB approach. In regards to the IRB modelling of these loans, the ABA recommends that APRA allow ADIs flexibility to determine if the exposures remain in the existing and future approved models. Where an account may have a temporary 'non-standard status', for example a loan

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approved under a servicing exception but meets performance continuously for 36 months, there may be value in retaining the exposure in existing models.

The ABA notes that in allowing the above application, APRA will have the ability to assess the appropriateness in the IRB reviews and model approval processes.

- **Multiple Defaults (Paragraph 106, APG 113)**

  "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..."

Given this is a new requirement under APG 113, the ABA recommend that:

(i) this requirement is to be addressed as part of future model developments; and

(ii) no adjustments need to be made to current model estimates.

- **Incomplete Workout Periods (Paragraph 124, APG 113)**

  "Incomplete workouts are defaulted exposures for which the recovery process is still in progress and recoveries are not yet certain. Incomplete workouts are generally associated with recent defaults but could also include defaults subject to an extended workout period……."

Given this is a new requirement under APG 113, the ABA recommend that:

(i) the items listed under Paragraph 124 around estimations for future recoveries for non-finalized losses can be addressed as part of future model developments; and

(ii) no adjustments are required to current LGD estimates.

Appendix C: Regulatory Reporting

Exposures to New Zealand subsidiaries

APRA has made changes to clarify that the exposures in New Zealand subsidiaries are not to be included from ARS 112.0/113.0 and are to be captured in ARS110.0

To ensure a consistent approach and reflect the consequential amendments, the ABA propose to exclude exposures in New Zealand subsidiaries from ARS 180.0 and ARS120.0.

ARF 110 Reporting: Consequential Amendments

The ABA notes that APRA has included the Security Financial Transactions (SFT) daily averaging requirement into the ARF110 reporting form. As previously noted by the ABA, there is a considerable burden in generating daily calculations, while the average of daily exposures differs little from the average of month-end exposures.

As such, the ABA proposed that ADIs calculate leverage ratios using average of month-end SFT exposures.

The ABA views this as a pragmatic and balanced approach as the current proposal would require ADIs to use the average of daily SFTs exposures for the calculation of the leverage ratio. Other components of leverage ratio are expected to stay at quarter-end observations. The average of daily exposures differs little from the average of month-end exposures.

Furthermore, calculating month-end exposures for SFTs is considerably less burdensome for ADIs. The ABA also notes that in the Australian context given the leverage ratio is not expected to be binding under APRA's framework.

As such, using the average of month-end SFT exposures in leverage ratio calculation provides a pragmatic balance between regulatory certainty and regulatory burden.