



# PRUDENTIAL PRACTICE GUIDE

## Draft APG 112 Capital Adequacy: Standardised Approach to Credit Risk

~~November 2022~~ June 2024

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# About this guide

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Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations, or APRA's prudential standards, but do not themselves create enforceable requirements.

*Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) sets out APRA's requirements for an authorised deposit-taking institution (ADI) in relation to the measurement of credit risk for regulatory capital purposes.

This PPG, *Prudential Practice Guide APG 112 Capital Adequacy: Standardised Approach to Credit Risk* (APG 112), aims to assist ADIs in complying with those requirements and, more generally, to outline prudent practices in relation to the management and measurement of credit risk. APG 112 should be read in conjunction with other relevant prudential standards and PPGs.

For capital, the relevant standards and guides include:

- *Prudential Standard APS 110 Capital Adequacy* (APS 110);
- *Prudential Practice Guide APG 110 Capital Adequacy* (APG 110);
- *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111);
- *Prudential Standard APS 120 Securitisation* (APS 120); and
- *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180).

For risk management, the relevant standards and guides include:

- *Prudential Standard APS 220 Credit Risk Management* (APS 220);
- *Prudential Practice Guide APG 220 Credit Risk Management* (APG 220);
- *Prudential Standard CPS 220 Risk Management* (CPS 220);
- *Prudential Practice Guide CPG 220 Risk Management* (CPG 220);
- *Prudential Practice Guide APG 223 Residential Mortgage Lending* (APG 223); and
- *Prudential Practice Guide CPG 235 Managing Data Risk* (CPG 235).

Subject to the requirements of APS 112, an ADI has the flexibility to structure its business operations in the way most suited to achieving its strategic objectives. Not all practices outlined in this PPG will be relevant for every ADI and some aspects may vary depending upon the size, business mix and complexity of the entity's operations.

# Glossary

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|                                       |   |
|---------------------------------------|---|
| <b>ADC</b>                            | Land acquisition, development and construction  |
| <b>ADI</b>                            | Authorised deposit-taking institution, as defined in the <i>Banking Act 1959</i> .              |
| <b>APS 001</b>                        | <i>Prudential Standard APS 001 Definitions</i>  |
| <b>APS 112</b>                        | <i>Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk</i>       |
| <b>APS 120</b>                        | <i>Prudential Standard APS 120 Securitisation</i>   |
| <b>APS 180</b>                        | <i>Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk</i>                   |
| <b>APS 220</b>                        | <i>Prudential Standard APS 220 Credit Risk Management</i>                                       |
| <b>Basel Committee</b>                | Basel Committee on Banking Supervision  |
| <b>Board</b>                          | Board of directors  |
| <b>CPS 220</b>                        | <i>Prudential Standard CPS 220 Risk Management</i>  |
| <b>Credit conversion factor (CCF)</b> | A factor that converts an off-balance sheet exposure into an on-balance sheet equivalent.       |
| <b>Credit risk mitigation (CRM)</b>   | A credit risk mitigation technique that meets the relevant requirements of APS 112.             |
| <b>Default</b>                        | Non-performing as defined in APS 220.   |
| <b>Loan-to-valuation ratio (LVR)</b>  | The ratio of the amount of the loan outstanding to the value of the property securing the loan. |
| <b>Risk-weighted assets (RWA)</b>     | Determined in accordance with the relevant requirements of APS 112.                             |
| <b>SFI</b>                            | Significant financial institution, as defined in APS 001.                                       |
| <b>SME</b>                            | Small- and medium-sized enterprise  |

# Introduction

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1. APS 112 sets out the capital requirements for credit risk under the standardised approach. It sets out the requirements for classifying different types of credit exposure and prescribes specific risk weights to apply to these exposures in calculating capital requirements.
2. An ADI must determine capital requirements by calculating its total risk-weighted assets (RWA). As shown in Figure 1, total RWA includes on-balance sheet and off-balance sheet credit risk exposures, as well as RWA for other risks. For credit risk, under the standardised approach, RWA are the product of an exposure amount multiplied by an APRA-prescribed risk weight.

**Figure 1. Standardised RWA calculation under APS 110**



*Under APS 110, the minimum CET1 capital requirement is calculated as 4.5 per cent multiplied by RWA, where RWA is determined as per Figure 1.*

3. Under APS 112, an ADI must establish and implement effective internal policies, processes, systems and controls to ensure that the risk weights assigned to its credit exposures align with the classifications in the prudential standard.
4. This PPG sets out good practice for an ADI in measuring capital required to be held for credit risk exposures. It provides guidance on applying the requirements of APS 112 to property and non-property asset classes, off-balance sheet commitments, external credit ratings and credit risk mitigation (CRM). It also includes worked examples on how to classify exposures into the appropriate asset class.

# Chapter 1 - Property exposures

*This section provides guidance on APS 112 Attachment A.*

5. Risk weights for property exposures are determined based on the type of loan - residential property, commercial property or land acquisition, development and construction (ADC) - and whether the exposure is classified as either a standard or non-standard loan. These are summarised in Table 1 below.

**Table 1. Property exposures**

| Loan type   | Standard loans   | Non-standard loans  |
|---|--|---|
| <b>Residential property</b>                           | <ul style="list-style-type: none"> <li>Segmented into owner-occupied, principal-and-interest, and other mortgages.</li> </ul>  | <ul style="list-style-type: none"> <li>Long-term interest-only loans, reverse mortgages, shared equity mortgages, loans to self-managed superannuation funds, and other loans that do not meet minimum criteria.</li> </ul> |
| <b>Commercial property</b>                            | <ul style="list-style-type: none"> <li>Segmented into exposures that are 'dependent' or 'not dependent' on cash flow generated by the property.</li> </ul>                   | <ul style="list-style-type: none"> <li>Loans that do not meet minimum criteria for origination and valuation.<sup>1</sup></li> </ul>  |
| <b>Land acquisition, development and construction</b> | <ul style="list-style-type: none"> <li>Exposures where the property security is not fully completed, with the exception of rural and future owner-occupied loans.</li> </ul> | <ul style="list-style-type: none"> <li>Loans that do not meet minimum criteria for origination and valuation.</li> </ul>  |

## Standard loans

6. An ADI must meet certain requirements in APS 112 (Attachment A) to classify a property exposure as a standard loan. This includes an ADI having unequivocal enforcement rights over a mortgaged property at all times. An ADI would meet this requirement where the ADI's claim on the property is legally enforceable.<sup>2</sup>
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,

<sup>1</sup> For exposures that are dependent on cash flow from the property, an assessment of tenancy profile relative to the maturity of the loan is required, otherwise the exposure is non-standard.

<sup>2</sup> An ADI's assessment of its ability to realise the value of a property within a reasonable timeframe would be based on the collateral agreement and legal contract underpinning the loan.

or associated controls, takes place no longer than three months post settlement and drawdown.

8. A mortgage over a lease of crown land may be categorised as a standard loan. APRA expects that an ADI would incorporate potential risks in mortgages over a lease of crown land in the valuation of a property as outlined in *Prudential Standard APS 220 Credit Risk Management* (APS 220).
9. To classify a property exposure as a standard loan, an ADI must also complete an assessment with a positive determination that the borrower can meet their repayment obligations. While APS 112 includes minimum criteria for this assessment, it is not intended to be a complete list of factors that a prudent ADI would consider. APRA expects an ADI to have appropriate controls and justification for implementing serviceability overrides, which may be used to make a positive determination of a borrower's ability to meet their repayment obligations.
10. APRA would generally expect an ADI to only consider the sale of the property as a factor in assessing whether a borrower can meet their repayment obligations where there is intent to have a signed contract of sale that is due to be completed within twelve months of origination (e.g. bridging loans). APRA expects these loans to be appropriately monitored by an ADI over this twelve-month period.
11. APRA does not expect a deed of priority to impact the unequivocal enforcement rights over a mortgaged property and preclude a loan being categorised as standard, provided that the deed does not limit the mortgagee's ability to enter into a sale.

## 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.
14. A long-term interest-only residential loan must be classified as a non-standard loan, where the loan-to-valuation ratio (LVR) is greater than 80 per cent and the contractual interest-only period is greater than five years or is not specified. Under APG 223, APRA expects that an ADI would undertake a serviceability assessment where there is an extension of an existing interest-only period. The table below provides some examples for categorising different types of interest-only loans.

**Table 2. Examples of classifying interest-only loans**

| Standard interest-only loans  | Non-standard interest-only loans   |
|---|--|
| <ul style="list-style-type: none"> <li>• A loan with an LVR greater than 80 per cent granted a four-year interest-only</li> </ul> | <ul style="list-style-type: none"> <li>• A loan with an LVR greater than 80 per cent and a six-year interest-only period.</li> </ul> |



| Standard interest-only loans  | Non-standard interest-only loans   |
|---|--|
| <p>extension, after completing an initial three-year interest-only period (totalling a consecutive seven-years over two contracts). A serviceability assessment was undertaken for the extension.</p> | <ul style="list-style-type: none"> <li>• A line of credit facility with no fixed interest-only period and an LVR greater than 80 per cent.</li> <li>• A loan with an LVR greater than 80 per cent and an initial interest-only period of three years, with an automatic extension of another three years without a serviceability assessment.</li> </ul> |

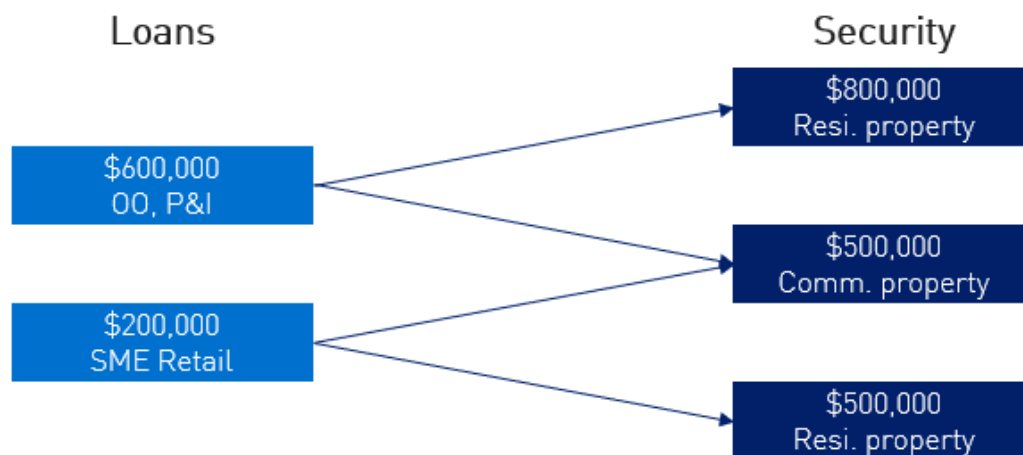
## Residential property

15. Under APS 112, capital requirements for standard residential mortgages are determined using risk weights that vary by the LVR of the loan. For the purpose of determining a loan's LVR, an ADI must appraise the value of the property consistent with the requirements in APS 220.
16. When determining the loan amount for the purposes of calculating LVR, deposit accounts that meet the requirements of APS 112 (Attachment H) can reduce the loan amount. Offset accounts would not meet the requirements for this purpose.
17. Where a loan is secured by multiple types of collateral, an ADI is required by APS 112 to categorise the loan type by the predominant collateral value used as security. The aggregate value of the mortgaged properties would be used for calculating LVR, prior to the application of haircuts and subject to the conditions in APS 112 (Attachment A, paragraph 11(b)). Examples of risk weighting a loan secured by multiple types of collateral is provided in Attachment A of this PPG.
18. A residential and commercial property loan that is secured by a predominant first mortgage over a single property and a second mortgage over a second property may be classified as a standard loan, even if the second mortgage does not fully meet the criteria to be a standard loan. However, in this case the second mortgage should not be included in the standard loan's LVR calculation.
19. Where a residential or commercial property loan is secured by multiple properties, an ADI must use the aggregate value of the mortgaged properties for the purpose of calculating LVR under APS 112 (Attachment A, paragraph 11(b)). An ADI may include the value of property-backed guarantees in the aggregate value of the mortgaged properties if the rights to the property in the event of default are economically equivalent to a standard mortgage. This could occur, for example, where a family member of a borrower guarantees the property to reduce the borrower's LVR, or a director of a company guarantees their personal property to reduce the LVR for their company's business loan. If the ADI has applied eligible CRM techniques to reduce the exposure amount, then the property must not be included in the LVR calculation under APS 112 (Attachment A, paragraph 13).
20. APRA considers that it would be reasonable for an ADI to treat an incomplete duplex residential property where the borrower is intending to occupy one duplex and rent the

other duplex for income as an owner-occupied standard loan. Although in principle the categorisation should be based on the predominant purpose of the loan, in this specific scenario APRA recognises this may not be easy to discern.

21. APS 112 is not prescriptive on circumstances where there are multiple loans secured by multiple securities, given the potential for a wide range of complex loan structures. In this case, a prudent ADI would follow an approach whereby:
- a) if the loans are economically and legally cross-collateralised, the loans would be aggregated and the properties would be aggregated in calculating the LVR (consistent with APS 112 (Attachment A, paragraphs 10 and 11)). The categorisation of the type of loan would then depend on the predominant collateral type (after aggregation and prior to the application of haircuts); or
  - b) if the loans are not economically and legally cross-collateralised (an example is shown in Figure 2), the collateral values may be allocated across the loans, while ensuring there is no double counting of collateral. A prudent ADI would not allocate with the purpose of optimising capital requirements. The categorisation of the type of loan or loans would depend on the predominant collateral type (after the allocation of collateral and prior to the application of haircuts).

**Figure 2. Example of multiple loans that are not cross-collateralised**



22. APRA expects an ADI would treat exposures to community housing providers as 'other' standard residential mortgages under APS 112 (Attachment A, paragraph 14(c)). Exposures to community housing providers would include borrowers that are registered with the National Regulatory System for Community Housing and/or the relevant state regulatory body, and the Australian Charities and Not-for-profits Commission.

## Commercial property

23. A commercial property exposure is a property exposure that is not residential property or ADC, as defined in APS 112.<sup>3</sup> Commercial property is segmented as either loans that are 'dependent' or 'not dependent' on property cash flows.
24. APRA expects that commercial property 'dependent' on property cash flows would typically include commercial loans to corporates or special purpose vehicles (SPVs), but the classification is not restricted to these borrower types. APRA expects the primary source of cash flows for commercial property 'dependent' on property cash flows would generally be lease or rental payments, or the sale of the property.
25. In determining whether a commercial property 'dependent' on property cash flows would be categorised as standard or non-standard, an ADI must assess whether there is a positive determination that the borrower can meet their repayment obligations. In making this determination, an ADI is required under APS 112 to assess the tenancy profile relative to the maturity of the loan. If the property is leased by multiple lessees, an ADI's assessment may consider whether the weighted average lease expiry (WALE) sufficiently exceeds loan maturity.
26. An example of a commercial property 'not dependent' on property cash flows would be a small- and medium-size enterprise (SME) loan that is secured by commercial property, but is serviced using business revenue.

## Land acquisition, development and construction

27. ADC loans are not restricted to loans to companies or SPVs and would include loans to individuals who are developing investment properties.
28. A prudent ADI would develop and maintain internal policies to define qualifying pre-sales and qualifying development costs for the purpose of determining the eligibility of ADC exposures for a 100 per cent risk weight.
  - a) For pre-sales, good practice is for the policy to require pre-sale contracts to be legally binding, conducted at arms-length, include a required non-refundable minimum deposit, and feature appropriate sunset dates consistent with expected completion dates. Good practice is also to include within the policy a maximum proportion of presales to a single entity or individual, or to foreign purchases.
  - b) For development costs, good practice is for the policy to clearly identify which development costs are considered by the ADI (for example, 'hard' costs, 'soft' costs, or total costs). Hard costs are typically related to the physical development of the property, while soft costs are other costs that may be incurred during the development process such as professional service or regulatory fees.

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<sup>3</sup> The definition of commercial property in APS 112 has a different meaning to that used in *Reporting Standard ARS 230.0 Commercial Property*.

# Chapter 2 - Non-property exposures

*This section provides guidance on APS 112 Attachment B.*

29. All exposures that are not property exposures must be risk weighted according to APS 112 (Attachment B), with the exception of unsettled and failed transactions and defaulted exposures. The table below summarises the key asset classes for non-property exposures.

**Table 3. Non-property exposures**

| Key asset classes               |                                 |
|---------------------------------|---------------------------------|
| Sovereign                       | Subordinated debt               |
| Domestic public sector entities | Equity                          |
| Bank                            | Leases                          |
| Corporate                       | Exposures through a third party |
| Retail                          | Other exposures                 |
| Margin lending                  |                                 |

## Sovereign exposures

30. Sovereign exposures include exposures to Australian and overseas central and subnational governments and other counterparties listed in APS 112, including revenue-raising subnational governments. An ADI may include revenue-raising Australian and overseas local councils as subnational governments within this definition.

## Domestic public sector entities

31. Public sector entities (PSEs) include entities that do not meet the definition of a sovereign exposure under APS 112. In classifying entities as domestic PSEs, an ADI would factor in the level of control or ownership by any level of the Australian Government or the Reserve Bank of Australia. Examples of domestic PSEs include:
- administrative bodies responsible to Australian governments that do not have specific revenue-raising powers, including agencies, statutory authorities and bodies created to enable legislation; and
  - government-provided services that do not have specific revenue-raising powers, including government schools, hospitals, and aged care facilities.

## Covered bonds

32. In relation to the criterion for covered bonds in APS 112 (Attachment B, paragraph 15(a)), the presence of the following would not preclude an ADI from applying the risk weights in Table 9 of APS 112: substitution assets (cash or short-term liquid and secured assets held in substitution of the primary assets to top up the cover pool for management purposes), or derivatives entered into for the purpose of hedging the risks arising in the covered bond program.

## Corporate exposures

33. A corporate exposure includes exposures to incorporated entities, associations, partnerships, proprietorships, trusts, funds and other entities that do not meet the definition of any other asset class. Exposures to individuals for business purposes, such as sole traders, would be categorised as an exposure to a corporate counterparty. A prudent ADI would apply careful judgement when categorising loans to individuals for business purposes, to ensure the risk of the exposure aligns with the asset class.
34. An exposure to an SME is defined as an exposure to a corporate counterparty or a corporate group with total consolidated annual revenue of less than \$75 million. Expectations for determining total consolidated annual revenue depend on the size of the exposure.
- a) Where the exposure is greater than or equal to \$5 million, an ADI is expected to use the average annual revenue reported to the ADI (provided this was no more than three years old), or might choose to use average annual revenue over, for example, a three-year period.
- b) 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 necessary. An ADI may use sources other than financial statements for the purpose of determining revenue, consistent with APS 220. APRA recognises that there might be certain 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, an ADI may treat the exposure as SME in accordance with APS 112 (Attachment B, paragraph 22). 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.
35. An SME counterparty may be one or several entities, which would be considered as a single aggregated exposure. For example, in the case of two SMEs that are a part of a group, the \$75 million threshold would apply to the ADI's aggregated exposure to the consolidated group.

35-36. [In relation to paragraph 25 of Attachment B to APS 112, an ADI which has been approved by APRA to use the internal ratings-based \(IRB\) approach to credit risk may](#)

use its IRB models as one of the inputs to assess whether an unrated general corporate entity should be deemed to be 'investment grade'.

## Specialised lending

### Project finance

36-37. Project finance is defined in APS 112 as a method of funding where an ADI looks primarily to the revenue generated by a single project as both the source of repayment and as security for the exposure. This type of financing is usually for large, complex installations that could include power plants, chemical processing plants, mines, transportation infrastructure, environment and telecommunications infrastructure. Project finance may take the form of financing the construction of a new installation or refinancing an existing installation, with or without improvements.

37-38. In project finance transactions, an ADI is usually paid solely, or almost exclusively, from the money generated by the output of the project. The borrower is usually a SPV that is not permitted to perform any function other than developing, owning and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the value of the project's assets. In contrast, if repayment of the exposure depends primarily on a well-established, diversified, contractually obligated end-user, it would generally be considered an exposure to that end-user and treated as a general corporate exposure.

### Object finance

38-39. Object finance is a method of funding the acquisition of specific assets, such as ships, aircraft, satellites, rail stock and motor vehicle fleets, where the repayment of the exposure is dependent on the cash flows generated by the specific assets that have been financed and pledged or assigned to an ADI.

39-40. A primary source of those cash flows might be rental or lease contracts with one or more third parties. In contrast, if the exposure is to a borrower whose financial condition and debt-servicing capacity enables it to repay the debt without undue reliance on the specifically pledged or assigned assets, the exposure would generally be treated as a general corporate exposure.

### Commodities finance

40-41. Commodities finance is short-term lending to finance reserves, inventories or receivables of commodities, such as crude oil, metals and crops, where the exposure will be repaid from the proceeds of the sale of the commodity and the borrower has no independent repayment capacity. This is the case when the borrower has no other activities or material assets on its balance sheet.

41-42. The structured nature of the financing would be designed to compensate for the credit quality of the borrower. An ADI's rating of the exposure would generally reflect its self-liquidating nature and the ADI's capacity to structure the transaction, rather than the credit quality of the borrower.

42-43. Commodities finance is generally distinguishable from exposures financing the reserves, inventories or receivables of other more diversified corporate borrowers, because an ADI would be able to rate the credit quality of the latter type of borrowers based on their broader ongoing operations. In such cases, the value of the commodity serves as risk mitigation rather than as the primary source of repayment, and the exposure would generally be treated as a general corporate exposure.

## Retail exposures

### 'Buy now, pay later' products

43-44. 'Buy now, pay later' (BNPL) products or services are typically provided for consumers to purchase goods or services, with the BNPL provider being repaid at a later date in predetermined instalments. BNPL exposures would be categorised as 'other retail' under APS 112.

44-45. For BNPL products, unused purchase limits are likely to be categorised as 'other commitments'. Some ADIs, however, may choose to adopt a higher credit conversion factor (CCF) where they assess there to be certain drawdown based on utilisation experience to date.

### Motor vehicle exposures

45-46. A loan to an individual for non-business purposes that is secured by a motor vehicle would be categorised as 'other retail' under APS 112.

## Subordinated debt

46-47. Subordinated debt includes any facility that is expressly subordinated to another facility, or has the effect of conveying economic subordination to another facility (APS 112 (Attachment B, paragraph 33)).

47-48. For the purpose of classifying an exposure as subordinated, an ADI may use a range of indicators of economic subordination. Examples are outlined in the below table.

**Table 4. Examples of indicators of subordination**

| Indicators of subordination for loans to a holding company that has revenue generating operating subsidiaries  |
|--|
| <ul style="list-style-type: none"><li>• the serviceability of holding company (HoldCo) debt depends on cash flow generated by the operating company (OpCo) through up-streaming of cash flow</li><li>• there are other secured or unsecured creditors at the OpCo level</li><li>• there are no financial guarantees provided by the OpCo or where an OpCo guarantee is held, the lender's access to OpCo's tangible assets or cash flow is limited or uncertain</li><li>• there are mechanisms that restrict the HoldCo's access to OpCo cash flow such as, but not limited to, lock-up covenants and a cash sweep mechanism</li><li>• the HoldCo has limited control over the OpCo's leverage</li></ul> |

## Other general indicators of subordination

- the ADI's facility is ranked behind other secured or unsecured creditors or policy holders of a borrowing entity or entities in a group (insofar as the related entities contribute to the serviceability of the facility) under a repayment waterfall in the event of default. However, policy holders' claims on prudentially regulated insurers and deposit holders' claims on ADIs may be excluded from a repayment waterfall for the purpose of determining economic subordination.

48-49. In assessing whether an ADI has an exposure which is economically subordinated, the ADI may choose to introduce materiality thresholds to assist it in classifying these exposures. A prudent ADI would have a documented policy detailing its approach to defining, using and reviewing any materiality thresholds used for this purpose.

## Equity

49-50. APS 112 (Attachment B, paragraphs 34-35) defines equity exposures on the basis of the economic substance of the instrument. For example, an instrument with the same structure as those permitted as Tier 1 Capital for an ADI may be categorised as an equity exposure. In addition, where an instrument embodies an obligation on the part of the issuer, the presence of any of the following factors would typically indicate the exposure has the economic substance of an equity exposure:

- a) the issuer may defer indefinitely the settlement of the obligation;
- b) the obligation requires (or permits at the issuer's discretion) settlement by issuance of a fixed number of the issuer's equity shares;
- c) the obligation requires (or permits at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares and, all else being equal, any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in the value of a fixed number of the issuer's equity share;<sup>4</sup> or
- d) the ADI holding the instrument has the option to require that the obligation be settled in equity shares unless, in the case of a traded instrument, the ADI has demonstrated that the instrument trades more like debt of the issuer, or, in the case of non-traded instruments, the ADI can demonstrate that the instrument would generally need to be treated as a debt position.

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<sup>4</sup> For certain obligations that require or permit settlement by issuance of a variable number of the issuer's equity shares, the change in the monetary value of the obligation is equal to the change in the fair value of a fixed number of equity shares multiplied by a specified factor. Those obligations would meet the conditions of paragraph 49c) if both the factor and the referenced number of shares are fixed. For example, an issuer may be required to settle an obligation by issuing shares with a value equal to three times the appreciation in the fair value of 1,000 equity shares. That obligation would be considered to be the same as an obligation that requires settlement by issuance of shares equal to the appreciation in the fair value of 3,000 equity shares.



## Leases

~~50-51.~~ A prudent ADI would adopt the following practices for lease exposures:

- a) robust risk management practices with respect to the location of the leased asset, its use, age and planned obsolescence;
- b) a robust legal framework establishing the ADI's legal ownership of the leased asset and its ability to exercise its rights as owner in a timely manner; and
- c) the difference between the rate of depreciation of the leased asset and the rate of amortisation of the lease payments would not be so large as to overstate the CRM effect of the leased asset.

## Exposures through a third party

~~51-52.~~ Exposures originated through third parties are generally riskier than exposures originated directly by the ADI (APS 112 (Attachment B, paragraph 41)). For secured lending, an ADI may not have direct and unequivocal access rights to the collateral. A prudent ADI would undertake appropriate due diligence to clearly understand the risk profile of these exposures.

~~52-53.~~ An example of an exposure originated by a third party would be an on-line lending platform, where the platform operator or another third party undertakes the credit assessment and approval of the borrowers under its own credit risk policies and procedures. Such exposures are typically referred to as peer-to-peer lending or marketplace lending. A prudent ADI would undertake appropriate due diligence on these exposures, as required by APS 220.

~~53-54.~~ There are some broader lending types that would not typically be categorised as exposures through a third party. These may for example include, but would not be limited to:

- a) securitisation exposures;
- b) subscription finance facilities;
- c) direct lending to third-party lenders; and
- d) purchased portfolios of assets.

## Exposures with currency mismatch

~~54-55.~~ For the purposes of determining whether an exposure is hedged (and meets the 90 per cent loan repayment amount threshold) under APS 112 (Attachment B, paragraph 44), an ADI would calculate natural and financial hedges after all other applicable haircuts, such as after haircuts to rental income, and may use actual repayments rather than a buffer repayment. An ADI would apply this test at loan origination and during any subsequent serviceability assessment.

55.56. Examples of foreign currency income that may create a natural hedge include remittances, rental incomes and salaries. This income would match the currency of the given loan for a natural hedge to exist.

# Chapter 3 - Off-balance sheet commitments

*This section provides guidance on APS 112 Attachment C.*

56-57. An off-balance sheet commitment is any arrangement that has been offered by an ADI and accepted by the borrower to extend credit, purchase assets or issue credit substitutes, as defined in APS 112 (Attachment C).

## Defining and measuring commitments

57-58. Indications that a borrower has accepted an arrangement may include the signing of an agreed committed term sheet or other document which has the effect of obligating an ADI to perform in the event the borrower meets all stipulated conditions of funding. For the avoidance of doubt, this would not necessarily require the execution of funding documents.

58-59. An arrangement that does not have a lending limit, and only stipulates the terms and conditions of future trades and limit establishment, would not generally constitute a commitment.

59-60. In some scenarios, there may be multiple commitments provided by an ADI, but only one of those commitments will be funded at any given time. As a principle in these scenarios, to prevent the duplication of capital requirements, the commitment to be risk weighted is the commitment that results in the largest RWA outcome. Examples include:

- a) where an ADI has provided commitments to fund different bids to the same project, when only one of those bids will ultimately be funded by the ADI; and
- b) where ~~a there is a commitment to refinance an existing facility condition precedent is for the borrower to refinance an existing facility with the ADI (e.g. the two commitments are for the existing facility and, upon acceptance of the condition precedent, the commitment to refinance).~~

61. ~~Under APS 112 (Attachment C, paragraph 3(a)), an arrangement does not need be treated as a commitment if, among other things, the ADI receives no fees or commissions to establish or maintain the arrangement (fees payable on drawdown do not need to be considered as fees in this context). Where an ADI's customer documentation for an arrangement contains both uncommitted and committed limits (with fees), then the uncommitted portion of the arrangement is not required to be treated as a commitment, provided that:~~

- ~~a) the committed and uncommitted limits can be clearly distinguished; and~~

b) the uncommitted limits meet all of the criteria in APS 112 (Attachment C, paragraph 3(b) to (e)).

62. For an arrangement to be excluded from the definition of commitment, an ADI must, among other things, satisfy the conditions in APS 112 (Attachment C, paragraph 3(d)), including that a creditworthiness assessment must be undertaken by an independent third party immediately prior to drawdown. In meeting this requirement, APRA expects an ADI to meet one of the following: It is reasonable for the level of credit assessment in this context to be proportionate to the time elapsed since the previous credit assessment, but not to the size of the drawdown. ADIs may use automated tools as part of a creditworthiness assessment; however, the extent of automation of creditworthiness checks should be proportionate to the size of debt, complexity and risk of the borrower. More guidance on automated credit assessments is provided in APG 220.

a) have in place processes that meet the following expectations:

i. a creditworthiness assessment is completed prior to approving a drawdown (unless an assessment has been completed within 24 hours (excluding weekends and public holidays));

ii. the creditworthiness assessment includes an auditable checklist that considers the current status of the following risk indicators of a borrower (to the relevant extent for SME borrowers):

o internal credit rating grade;

o if externally rated, external credit assessment institution (ECAI) rating grade downgrades since the previous risk grade review;

o limit excesses;

o days and amount in arrears;

o missed collateral calls;

o overdue financial covenant reviews;

o financial covenant breaches;

o overdue risk grade reviews or aged ratings;

o material public disclosures or news; and

o any other sign of credit deterioration; and

iii. a relationship manager may complete the checklist provided that the outcome of a drawdown request (for example, 'drawdown approved' or 'refer out to credit') is determined by the checklist. An automated process is considered independent and is better practice; or

b) have in place processes, policies and procedures that meet the following expectations:

i. policies and procedures would stipulate the conditions, with reference to the risk indicators listed below, that would trigger an immediate review of a borrower's approved limit by the credit function. Policies and procedures

would detail how drawdown requests are to be processed prudently while a review is in progress.;

ii. at a minimum, the current status of the following risk indicators (to the relevant extent for SME borrowers) would be monitored<sup>5</sup>:

- o if externally rated, ECAI rating grade downgrades since the previous risk grade review;
- o limit excesses;
- o days and amount in arrears;
- o missed collateral calls;
- o overdue financial covenant reviews;
- o financial covenant breaches;
- o overdue risk grade reviews or aged ratings; and
- o material public disclosures or news; and

iii. policies and procedures would detail how drawdown requests are to be processed prudently when a borrower is given a period of time to rectify issues such as an excess.

63. While better practice is for an ADI to have a consistent approach in choosing either paragraph 62(a) or 62(b) of this PPG, selection may be made at the business unit level. Irrespective of the approach chosen, for arrangements that are excluded from the definition of a commitment, ADIs would be expected to conduct monitoring of the:

- a) volume of limits excluded from the definition of a commitment;
- b) rate of conversion or utilisation of uncommitted limits to commitments; and
- c) proportion of customers that default within 12 months of drawdown of uncommitted limits and resulting losses.

~~60. Under APS 112 (Attachment C, paragraph 3(a)), an arrangement does not need to be treated as a commitment if, among other things, the ADI receives no fees or commissions to establish or maintain the arrangement (fees payable on drawdown do not need to be considered as fees in this context). Where an ADI's customer documentation for an arrangement contains both uncommitted and committed limits (with fees), then the uncommitted portion of the arrangement is not required to be treated as a commitment, provided that:~~

~~61. the committed and uncommitted limits can be clearly distinguished; and~~

~~62. the uncommitted limits meet all of the criteria in APS 112 (Attachment C, paragraph 3).~~

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<sup>5</sup> Monitored in this context means where any risk indicator has exceeded their threshold, relevant personnel would be alerted immediately to initiate a review of the borrower's approved limit by the credit function.

~~63-64.~~ Under APS 112 (Attachment C, paragraph 6), where an ADI has given a commitment to provide an off-balance sheet exposure, it may apply the lower of the CCFs applicable to the commitment and the off-balance sheet exposure. For example, if an ADI has a commitment to open short-term self-liquidating trade letters of credit arising from the movement of goods that also meets the definition of a performance-related contingency, a 20 per cent CCF may be applied (instead of a 50 per cent CCF).

~~64-65.~~ Under APS 112 (paragraph 21), an ADI must calculate the capital requirement for any securities it lends or posts as collateral, where the risk remains with the ADI, in addition to any RWA arising from its exposure to a securities financing transaction (SFT) counterparty. This would not apply to posted collateral relative to derivative transactions that is treated in accordance with APS 180.

## Credit conversion factors

~~65-66.~~ Where a commitment exists, an ADI must multiply the committed but undrawn amount of exposure by the relevant CCF and then apply the relevant prescribed risk weight for that exposure. The following paragraphs provide clarity with regards to off-balance sheet commitments as listed in Table 5.

**Table 5. CCFs**

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

## Direct credit substitutes

~~66-67.~~ 'Direct credit substitutes' are irrevocable off-balance sheet obligations that carry the same credit risk as a direct extension of credit. This includes where an ADI enters into an undertaking:

- a) to make a payment to a third party on behalf of a counterparty, as a result of that counterparty failing to meet a financial obligation. In this case, the risk of loss reflects the creditworthiness of the counterparty; or
- b) with a counterparty to acquire a potential claim on a third party, in the event of default by the third party. In this case, the risk of loss reflects the creditworthiness of the third party.

~~67-68.~~ Examples of 'direct credit substitutes' include general guarantees of debts such as standby letters of credit which serve as financial guarantees for loans and securities, and acceptances, including endorsements that are similar to acceptances. This would also include insurance standby letters of credit, which are issued by an ADI to an insurer whereby the ADI guarantees payment to the insurer in the event that its reinsurer defaults. Standby letters of credit would be direct credit substitutes, because the primary purpose of a letter of credit is to support the claims paying ability of a counterparty, which is a monetary or financial obligation.

~~68-69.~~ APRA expects ADIs to categorise merchant acquiring exposures (MAEs) as 'direct credit substitutes'. MAEs are exposures where there is potential loss to an ADI when a merchant fails to deliver pre-paid goods or services and is unable to provide a refund to the consumer due to deteriorating creditworthiness. An ADI would categorise an MAE as a direct credit substitute because of the dependence on the creditworthiness of the merchant.

## Sale and repurchase agreements and asset sales with recourse

~~69-70.~~ 'Sale and repurchase agreements' include agreements to provide securities (or other assets) in exchange for cash, with an agreement to repurchase the securities (or other assets) at a future period. 'Asset sales with recourse' would include agreements or sales by an ADI where the holder of the asset is entitled to 'put' the asset back to the ADI within an agreed period or under certain prescribed circumstances (such as where there is a deterioration in the value or credit quality of the asset concerned).

## Lending of securities or posting of securities as collateral

~~70-71.~~ 'Lending of securities or posting of securities as collateral' would typically include exposures that arise from an ADI's lending of securities as collateral. Examples would include off-balance sheet exposures that arise out of repo-style transactions, such as repurchases or reverse repurchases, and securities lending or securities borrowing transactions.

## Forward asset purchases, forward deposits and partly paid shares and securities

71-72. 'Forward asset purchases, forward deposits and partly paid shares and securities' represent commitments with certain drawdown.

72-73. 'Forward asset purchases' include commitments from a counterparty to purchase, at a specified future date and on pre-arranged terms, a security or another asset from a third party. It also includes written put options on specified assets with the character of a credit enhancement.<sup>6</sup>

73-74. 'Forward deposits' include agreements between an ADI and another party, where the ADI places a deposit at an agreed rate of interest with that party, and the party returns the deposit to the ADI with an agreed rate of interest (at a predetermined future date).

74-75. 'Partly-paid shares and securities' include any amounts on uncalled paid shares and securities held by the ADI that represent commitments with certain drawdown by the issuer at a future date. In these cases, the ADI holds the credit risk associated with the underlying asset. These transactions would be assigned to asset classes based on the type of assets or underlying issuer(s) of the securities, rather than necessarily the principal counterparty to the transaction.

## Other off-balance sheet items that are credit substitutes

75-76. This transaction type includes credit substitutes that are not explicitly included in any other category (such as the direct credit substitute category).

## Unsettled securities, commodities and foreign exchange transactions accounted for at settlement date

76-77. This transaction type relates to securities, commodities and foreign exchange transactions which have not appeared on the ADI's balance sheet at the settlement date. The CCF would only apply to the unsettled exposure amount of these transactions.

## Other commitments with certain drawdown

77-78. This transaction type would typically include an exposure where a loan is approved but not yet advanced, or where drawdown has been scheduled but not yet occurred. This would include, for example, development exposures whereby the ADI advances funds on the completion of each stage.

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<sup>6</sup> Where an ADI purchasing the asset has an unequivocal right to substitute cash settlement in place of accepting delivery of the asset, and the price on settlement is calculated with reference to a general market price indicator (and not to the financial condition of any specific entity), the purchase would instead be treated under APS 180.



## Note issuance and revolving underwriting facilities

78-79. These transactions occur in the context of a borrower drawing down funds up to a prescribed limit, during a predefined period, by making repeated note issuances to the market. Where there are outstanding notes that are unable to be placed by the borrower, an ADI providing a note issuance facility takes up the unplaced amount and an ADI agreeing to a revolving underwriting facility provides funding as a committed underwriter.

79-80. The CCF would apply to these transaction types regardless of the maturity of the underlying facility.

## Performance-related contingencies

80-81. Performance-related contingencies are contingent liabilities arising from an irrevocable obligation to pay a third party in the event a counterparty fails to fulfil or perform a contractual non-monetary obligation, such as the delivery of goods by a specified date. In these transactions, the risk of loss depends on a future event which is not necessarily related to the creditworthiness of the counterparty.

81-82. Examples of this transaction type include the issue of performance bonds, bid bonds, warranties and standby letters of credit in relation to a non-monetary obligation of a counterparty.

## Other commitments

82-83. This category would capture commitments which do not qualify for another transaction type. Examples include:

- a) undrawn credit card exposures;
- b) a mortgage loan that allows redraw and has been paid down by the borrower ahead of schedule, or the undrawn component of an equity line of credit facility. The CCF would be applied to the off-balance sheet portion; and
- c) where an ADI has extended a line of credit for working capital to a business.

## Short-term self-liquidating trade letters of credit arising from the movement of goods

83-84. This category includes trade-related contingencies, such as documentary credit that is secured by an underlying shipment of goods for both issuing and confirming ADIs. The arrangement is short term where the maturity is less than 12 months, as defined in APS 112. The CCF would apply to both the issuing and confirming ADIs.

84-85. These transactions are self-liquidating where:

- a) the buyer or supplier has fulfilled their contractual obligations; and
- b) the sale proceeds have been paid directly to the trade finance exposure.

85-86. To confirm that these facilities are self-liquidating, an ADI would typically have controls and processes in place to ensure that:

- a) there is clear visibility over the underlying supply or offtake contracts, so that they match the terms of the trade finance exposure;
- b) payment terms are met on the date of the contracted maturity;
- c) payment is made to an account with the ADI to directly extinguish the trade finance exposure, or, where payment is via a third party, a legal structure that aligns funds from the buyer(s) of the underlying trade flow to liquidate the trade exposure; and
- d) the underlying repayment source (receivable) cannot be on-sold.

### **Intraday limits**

86-87. Intraday limits are arrangements designed to facilitate outward electronic fund transfers irrespective of a customer's available funds at the time of the transaction. The limit must be provided on an intraday basis: in other words, it must be fully cleared by the end of the day. Any amount that remains uncleared at the end of the day must be immediately risk weighted as a drawn credit exposure.

### **Irrevocable standby commitments under industry support arrangements**

87-88. This category includes industry support commitments that have been approved by APRA.

# Chapter 4 - External credit ratings

*This section provides guidance on APS 112 Attachment F.*

~~88-89.~~ An ADI may use external credit ratings that meet the criteria set out in APRA's *Guidelines on Recognition of an External Credit Assessment Institution* (ECAI). APRA expects that an ADI would treat exposures rated by credit rating agencies that do not meet the criteria in these guidelines as unrated exposures. Where an ADI undertakes internal due diligence analysis that produces a lower quality rating than the relevant external rating, the internal rating may be used to meet the requirements under APS 112 (Attachment F, paragraph 3).

~~89-90.~~ APRA expects an ADI would not choose ratings provided by different ECAs to manipulate credit ratings of counterparties. An ADI would also not arbitrarily change the use of ECAs. If there is only one rating by an ECA chosen by the ADI for a particular exposure, that rating would be used to determine the risk weight of the exposure.

~~90-91.~~ APRA expects external ratings to reflect the entire amount of credit risk exposure an ADI has with regard to all payments owed to it. For example, if the ADI is owed both principal and interest, the rating would fully consider and reflect the credit risk associated with the repayment of both principal and interest.

~~91-92.~~ The sophistication of the due diligence that an ADI would undertake to ensure that external ratings appropriately and conservatively reflect the creditworthiness of the counterparty would be appropriate to the size and complexity of the ADI's activities. An ADI would take reasonable steps to independently assess the operating and financial performance levels and trends through internal credit analysis and other analytics, as appropriate for each counterparty. An ADI would be able to access information about their counterparties on a regular basis to complete such due diligence analysis.

~~92-93.~~ For exposures to counterparties belonging to consolidated groups, due diligence would, to the extent possible, be performed at the individual entity level to which there is a credit exposure. In evaluating the repayment capacity of a counterparty, an ADI would typically consider the support of the group and the potential for it to be adversely impacted by problems in the group.

## Domestic and foreign currency exposures

~~93-94.~~ When an exposure arises through an ADI's participation in a loan that has been extended, or has been guaranteed against convertibility and transfer risk, by eligible multilateral development banks (MDBs), APRA considers its convertibility and transfer risk to be effectively mitigated. Eligible MDBs are listed in APS 112 (Attachment B, paragraph 3).

~~94.95.~~ In such cases, for risk weighting purposes, the borrower's domestic currency rating may be used instead of its foreign currency rating. In the case of a guarantee against convertibility and transfer risk, the local currency rating can be used only for the portion that has been guaranteed. The portion of the loan not benefiting from such a guarantee would be risk weighted based on the foreign currency rating.

## Implicit government support

~~95.96.~~ Under APS 112 (Attachment B, paragraph 13), an ADI must not use ratings that incorporate assumptions of implicit government support when assigning risk weights to bank counterparty exposures. Implicit government support refers to the notion that a government would act to prevent creditors from incurring losses in the event of a default.

~~96.97.~~ If available, APRA expects an ADI to utilise an ECAI's 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 in the credit rating used. To make these adjustments, an ADI may use information on rating methodologies provided by ECAs.

# Chapter 5 - Credit risk mitigation

*This section provides guidance on APS 112 Attachments G to J.*

~~97~~.~~98~~. An ADI is able to use a number of CRM techniques under APS 112 to reduce its credit risk capital requirements. Requirements for the recognition of these techniques for capital purposes are set out in APS 112 (Attachments G to J).

~~98~~.~~99~~. Examples of credit risk mitigation include where exposures are collateralised in whole or in part with cash or securities, where a loan is guaranteed by a third party, or where an ADI purchases a credit derivative to offset credit risk. An ADI may also agree to net loans against deposits from the same counterparty, subject to meeting the requirements in APS 112 (Attachment H).

~~99~~.~~100~~. The CRM techniques discussed in this section are applicable to banking book exposures that are risk weighted under the standardised approach (covered in APS 112).

~~100~~.~~101~~. While the use of CRM techniques reduces or transfers credit risk, they may also give rise to other risks, such as legal, operational, liquidity and market risks. A prudent ADI would employ robust processes to control these risks, including, but not limited to: strategy, consideration of the underlying credit, valuation, policies and procedures, systems, control of roll-off risks, and management of concentration risk arising from an ADI's use of CRM techniques and its interactions with an ADI's overall credit risk profile.

~~101~~.~~102~~. Where a CRM technique is applied on a transaction, the capital requirements of the exposure would not be higher than if CRM were not applied.

~~102~~.~~103~~. An ADI would not double-count the effect of CRM. That is, the capital requirements of an exposure would not be reduced where its risk weighting already reflects the effect of CRM (for example, the risk weighting of an exposure that has already been reduced, as reflected in the issue-specific rating of the exposure).

## Collateralised transactions

~~103~~.~~104~~. Under APS 112 (Attachment G), an ADI may apply CRM techniques to transactions secured by received collateral. A collateralised exposure is a transaction where:

- a) an ADI has a credit exposure or a potential credit exposure; and
- b) that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or third party on behalf of the counterparty.

~~104~~.~~105~~. An ADI may opt for either:

- a) the simple approach, which replaces the risk weight of the counterparty with the risk weight of the collateral for the collateralised portion of the exposure (generally subject to a 20 per cent floor under APS 112 (Attachment G, paragraph 16)); or
- b) the comprehensive approach, which allows a more precise offset of collateral against exposures, by effectively reducing the exposure amount by a volatility-adjusted value ascribed to the collateral (under APS 112 (Attachment G, paragraph 23)).

105.106. Under APS 112 (Attachment G, paragraph 7), an ADI must take all necessary steps to ensure the legal mechanism by which collateral is pledged or transferred provides the ADI the legal right to liquidate or take legal possession of it, in a timely manner, when necessary. These necessary steps may include registering it with a registrar, or exercising a right to net or set off in relation to the title transfer of the collateral.

106.107. An ADI would apply capital requirements to both sides of a transaction. For example, both sides of a repo-style transaction (i.e. repurchase/reverse repurchase and securities lending/borrowing transactions) would be subject to capital requirements, as would the posting of securities in connection with derivatives exposures or with any other borrowing transaction.

107.108. Where the ADI, acting as an agent, arranges a repo-style transaction between a customer and a third party and provides a guarantee to the customer that the third party will perform its obligations, then the risk to the ADI is the same as if the ADI had entered into the transaction as a principal. In such circumstances, the ADI would calculate capital requirements as if it were itself the principal.

108.109. Under the comprehensive approach, when taking collateral, an ADI may calculate its adjusted exposure to the counterparty in order to take account of the risk mitigating effect of that collateral. In doing so, an ADI would use the supervisory haircuts under APS 112 (Attachment G, Table 23) to adjust both the amount of the exposure to the counterparty and the value of any collateral received in support of that counterparty to take account of possible future fluctuations in the value of either collateral or exposure. Unless either side of the transaction is cash or a zero haircut is applied, the volatility-adjusted exposure amount would be higher than the nominal exposure and the volatility-adjusted collateral value would be lower than the nominal collateral value.

109.110. Under the comprehensive approach, the size of the haircuts that an ADI must use depends on the prescribed holding period for the transaction. For this purpose, the holding period is the period of time over which exposure or collateral values are assumed to move before the ADI can close out the transaction. The supervisory prescribed minimum holding period is used as the basis for the calculation of the standard supervisory haircuts.

110.111. Currency mismatches are allowed under both the simple and comprehensive approaches. Under the simple approach, there is no specific treatment for currency mismatches, given a risk weight floor of 20 per cent is generally applied on the secured portion of an exposure (APS 112 (Attachment G, paragraph 16)). Under the comprehensive approach and in the case of guarantees and credit derivatives, a

specific adjustment for currency mismatches is prescribed (APS 112 (Attachment G, paragraph 23)).

~~411.~~112. For collateralised over-the-counter (OTC) transactions, exchange traded derivatives and long settlement transactions, an ADI that is a significant financial institution (SFI) must use APS 180 to calculate the exposure amount, as outlined in APS 112 (paragraph 20(a)(ii)).

~~412.~~113. Covered bonds may be considered eligible financial collateral where they meet the definition under APS 112 (Attachment G, paragraph 14(c)) and would receive a haircut as specified in APS 112 (Table 23).

## Netting

~~413.~~114. Where SFTs are subject to a master netting agreement, whether they are held in the banking book or trading book, an ADI may choose not to recognise the netting effects in calculating capital requirements. In that case, each transaction will be subject to a capital treatment as if there were no master netting agreement.

## Guarantees

~~414.~~115. Guarantees may include, but are not limited to, credit risk insurance and trade finance risk participation agreements.

~~415.~~116. For a guarantee to be recognised as eligible CRM, it must be unconditional (APS 112 (Attachment I, paragraph 2(e))). This means that the guarantor would be unconditionally obliged to pay out in a timely manner in the event that the underlying counterparty fails to make a payment. The guarantor would have no direct control over the decision to pay out, and the ADI would have full direct control in enforcing the guarantee to pay out.

## Credit derivatives

~~416.~~117. Only credit default swaps and total return swaps that provide credit protection equivalent to guarantees are eligible for recognition. The following exception applies, however: where an ADI buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection would not be recognised.

~~417.~~118. First-to-default and all other *n*th-to-default credit derivatives (by which an ADI obtains credit protection for a basket of reference names and where the first- or *n*th-to-default among the reference names triggers the credit protection and terminates the contract) are not eligible as a CRM technique and therefore would not provide any regulatory capital relief. In transactions where an ADI provides credit protection through such instruments, it would apply the treatment described in APS 180.

~~418.~~119. Where an ADI transfers a portion of the risk of an exposure in one or more tranches to a protection seller or sellers and retains some level of the risk of the loan, and the risk transferred and the risk retained are of different seniority, tranching risk is created.

Such transactions are considered synthetic securitisations with the relevant requirements set out in APS 120.

~~119.~~120. Under APS 112 (Attachment J, paragraph 21), for the purpose of determining maturity for a credit derivative, an ADI would account for any clause or incentive within the credit derivative contract that may reduce its maturity so that the shortest possible effective maturity is used. For example, if the protection seller has a call option, the maturity is the first call date. Likewise, if the protection buyer owns the call option and has a strong incentive to call the transaction at the first call date, for example, because of a step-up in cost from this date on, the effective maturity is the remaining time to the first call date.



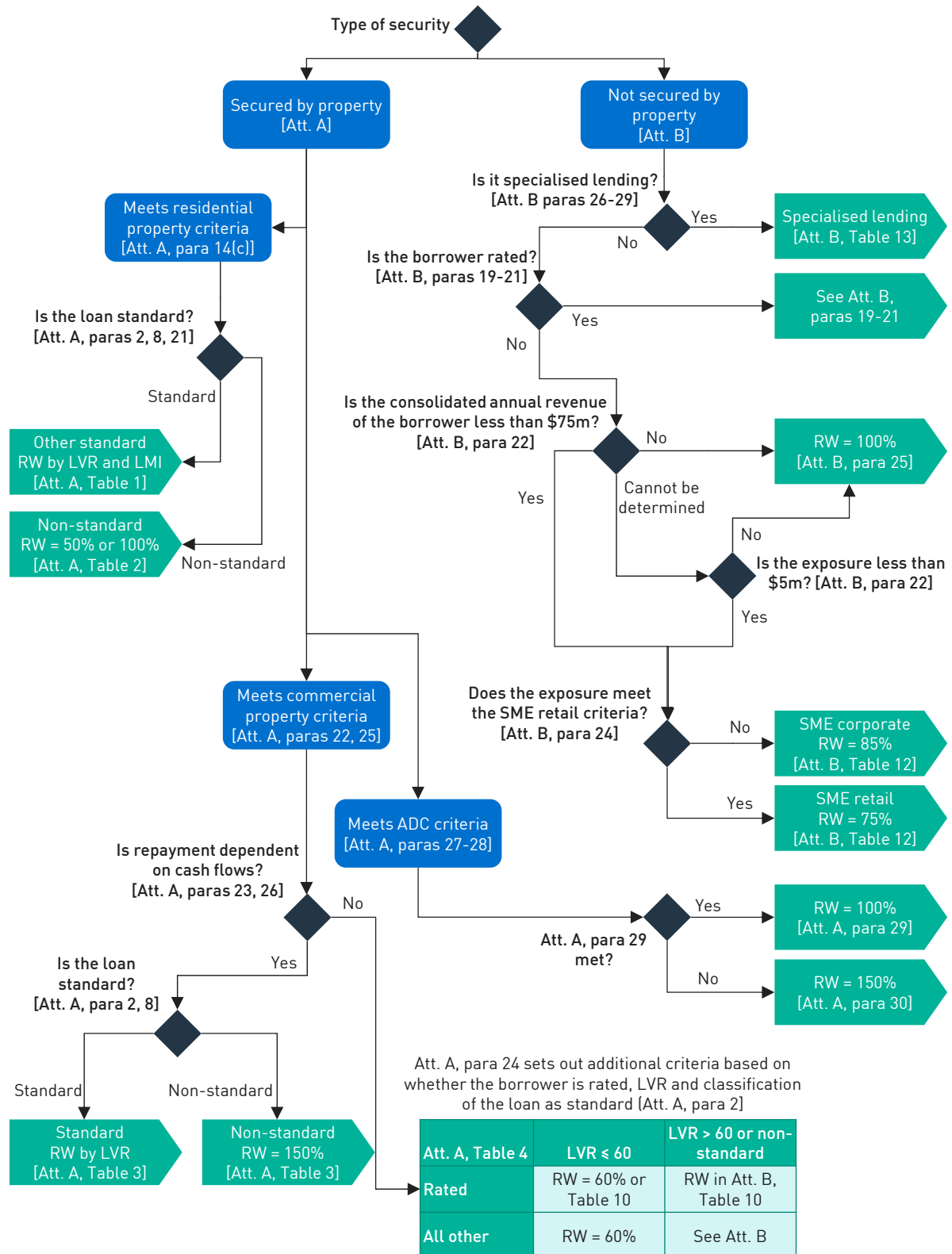
# Attachment A – Property exposures examples

The following examples explain how to apply the predominance test and risk weights to property exposures secured by mixed collateral.

| Example   | Scenario   | Treatment under APS 112   |
|---|--|---|
| <b>Example 1:<br/>Residential property loan secured by mixed collateral</b> | <ul style="list-style-type: none"> <li>A \$500,000 loan is secured by a residential property with a collateral value of \$500,000 and a commercial property with a collateral value of \$300,000.</li> <li>The loan is a principal-and-interest, owner-occupied standard loan.</li> </ul>  | <ul style="list-style-type: none"> <li>The loan would be treated as a residential property loan because the predominant security based on collateral value is residential property (APS 112 (Attachment A, paragraph 14)).</li> <li>Both the residential property and the commercial property may be used as collateral in determining LVR (APS 112 (Attachment A, paragraph 11(b))). However, the commercial property collateral would receive a 40 per cent haircut, meaning the value of the commercial property to include in the LVR calculation is reduced to \$180,000.</li> <li>The loan would have a 74 per cent LVR and receive a 35 per cent risk weight (APS 112 (Attachment A, Table 1)).</li> </ul> |
| <b>Example 2:<br/>Commercial property loan secured by mixed collateral</b>  | <ul style="list-style-type: none"> <li>A \$500,000 loan is secured by a residential property with a collateral value of \$300,000 and a commercial property with a collateral value of \$500,000.</li> <li>The loan is also dependent on the properties' cash flows, as it meets the definition under APS 112 (Attachment A, paragraph 23).</li> </ul> | <ul style="list-style-type: none"> <li>The loan would be treated as a commercial property exposure because the predominant security is commercial property (APS 112 (Attachment A, paragraph 22)). Both the residential property and the commercial property can be used as collateral in determining the loan's LVR.</li> <li>The ADI assesses that the borrower is able to meet its repayment obligations and categorises the loan as standard (APS 112 (Attachment A, paragraph 5)).</li> <li>The loan has a 62.5 per cent LVR and would receive a risk weight of 90 per cent (APS 112 (Attachment A, Table 3)).</li> </ul>  |

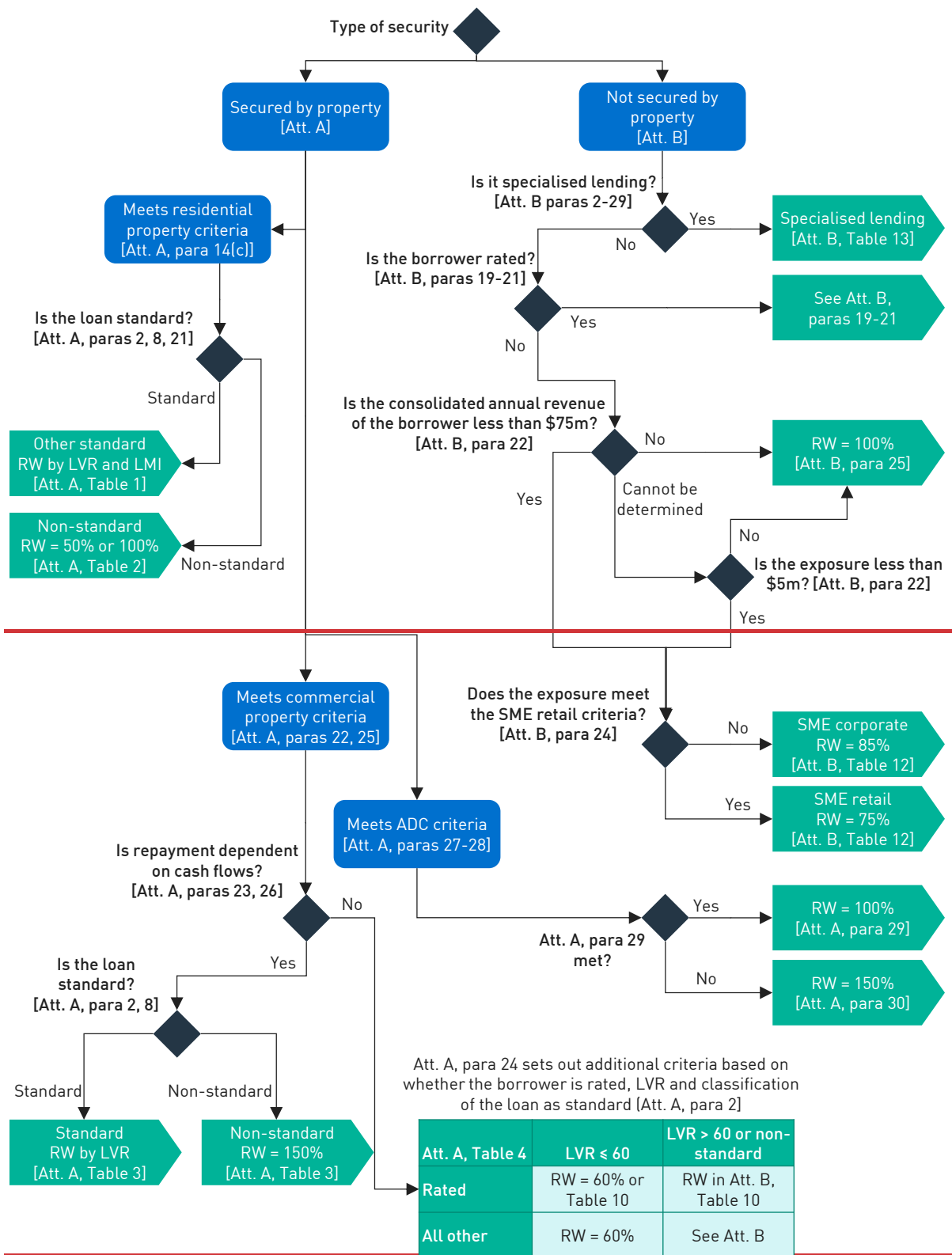
# Attachment B – SME treatment example

This Attachment provides an indicative example for the treatment of the on-balance sheet component of an SME loan under APS 112.



Att. A, para 24 sets out additional criteria based on whether the borrower is rated, LVR and classification of the loan as standard [Att. A, para 2]

|           | Att. A, Table 4 | LVR ≤ 60             | LVR > 60 or non-standard |
|-----------|-----------------|----------------------|--------------------------|
| Rated     |                 | RW = 60% or Table 10 | RW in Att. B, Table 10   |
| All other |                 | RW = 60%             | See Att. B               |



# Attachment C – Summary of risk weights

This Attachment sets out a summary of the finalised risk weights and CCFs for standardised ADIs. The relevant sections of APS 112 should be read to obtain the specific capital treatment for the exposure. This section covers Attachments 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.      |
|---|--------------------------|--------------------|---|----------|--------------|----------|-----------|------|-------------------|
| <b>Residential mortgages</b>                          |                          |                    |   |          |              |          |           |      |                   |
| <b>Owner-occupied principal-and-interest</b>          | LMI                      | 20                 | 25                                      | 30       | 35           | 40       | 55        | 70   | Table 1           |
|   | No LMI                   | 20                 | 25                                      | 30       | 35           | 50       | 70        | 85   | Table 1           |
| <b>Other standard residential property</b>            | LMI                      | 25                 | 30                                      | 40       | 45           | 50       | 70        | 85   | Table 1           |
|   | No LMI                   | 25                 | 30                                      | 40       | 45           | 65       | 85        | 105  | Table 1           |
| <b>Reverse mortgages</b>                              |                          | 50                 | 50                                      | 100      | 100          | 100      | 100       | 100  | Table 2           |
| <b>All other non-standard loans</b>                   |                          | 100                | 100                                     | 100      | 100          | 100      | 100       | 100  | Table 2           |
| Risk weight (%)                                       | LVR                      | ≤60                | 60.01-80                                | >80      | APS 112 Ref. |          |           |      |                   |
| <b>Commercial property</b>                            |                          |                    |   |          |              |          |           |      |                   |
| <b>Dependent on property cash flows</b>               | Standard                 | 70                 | 90                                      | 110      | Table 3      |          |           |      |                   |
|   | Non-standard             | 150                |   |          | Table 3      |          |           |      |                   |
| <b>Not dependent on property cash flows</b>           | 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.      |
| <b>Land acquisition, development and construction</b> |                          |                    |   |          |              |          |           |      |                   |
| 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.         |
|--|---------------------------|-----|----|---------------------------|------|------|---------|----------------------|
| <b>Non-property exposures</b>            |                           |     |    |                           |      |      |         |                      |
| <b>Sovereign</b>                         |                           | 0   | 20 | 50                        | 100  | 150  | 100     | Table 5              |
| <b>Domestic public sector entities</b>   |                           | 20  | 50 | 50                        | 100  | 150  | 50      | Table 6              |
| <b>Bank</b>                              | 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              |
| <b>Covered bonds</b>                     |                           | 10  | 20 | 20                        | 50   | 100  |         | Table 9              |
| Risk weight (%)                          | Rating grade              | 1   | 2  | 3                         | 4    | 5, 6 |         | APS 112 Ref.         |
| <b>Corporate exposures</b>               |                           |     |    |                           |      |      |         |                      |
| <b>General corporate</b>                 | Long-term                 | 20  | 50 | 75                        | 100  | 150  |         | Table 10             |
|  | Short-term issue-specific | 20  | 50 | 100                       | 150  |      |         | Table 11             |
| Risk weight (%)                          |                           | %   |    |                           |      |      |         | APS 112 Ref.         |
| <b>SME retail</b>                        |                           | 75  |    |                           |      |      |         | Table 12             |
| <b>SME corporate</b>                     |                           | 85  |    |                           |      |      |         | Table 12             |
| <b>General corporate – other</b>         |                           | 100 |    | <a href="#">or 85/110</a> |      |      |         | Attach. B Para 25    |
| <b>Project finance</b>                   |                           | 110 |    |                           |      |      |         | Table 13             |
| <b>Object and commodities finance</b>    |                           | 100 |    |                           |      |      |         | Table 13             |
| <b>Retail exposures</b>                  |                           |     |    |                           |      |      |         |                      |
| <b>Credit cards</b>                      |                           | 75  |    |                           |      |      |         | Table 14             |
| <b>Other retail</b>                      |                           | 100 |    |                           |      |      |         | Table 14             |
| <b>Margin lending exposures</b>          |                           |     |    |                           |      |      |         |                      |
| <b>Eligible financial collateral</b>     |                           | 20  |    |                           |      |      |         | Attach. B Para 32    |
| <b>Other</b>                             |                           | 100 |    |                           |      |      |         | Attach. B Para 32    |
| <b>Subordinated debt exposures</b>       |                           |     |    |                           |      |      |         |                      |
| <b>Subordinated debt</b>                 |                           | 150 |    |                           |      |      |         | Attach. B Para 33    |
| <b>Equity exposures</b>                  |                           |     |    |                           |      |      |         |                      |
| <b>Listed on recognised exchange</b>     |                           | 250 |    |                           |      |      |         | Attach. B Para 38(a) |
| <b>Not listed on recognised exchange</b> |                           | 400 |    |                           |      |      |         | Attach. B Para 38(b) |

| Risk weight (%)  | %    | APS 112 Ref.      |
|--|------|-------------------|
| <b>Lease exposures</b>   |      |                   |
| Residual value ≤10% Tier 1 Capital   | 100  | Table 15          |
| Residual value >10% Tier 1 Capital   | 250  | Table 15          |
| <b>Exposures originated through a third party</b>  |      |                   |
| Exposures through a third party  | 150  | Attach. B Para 41 |
| <b>Other exposures</b>   |      |                   |
| 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          |
| <b>Currency mismatch</b>   |      |                   |
| Risk weight multiplier for certain exposures with currency mismatch                                  | 1.5x | Attach. B Para 43 |
| <b>Credit conversion factors (CCFs)</b>  |      |                   |
|  | %    | 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          |



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