



Prudential Standard APS 220

Credit Quality

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires an authorised deposit-taking institution (ADI) to control credit risk by adopting prudent credit risk management policies and procedures. These policies and procedures must apply, in particular, to the recognition, measurement and reporting of, and provisioning for, impaired facilities.

The key requirements of this Prudential Standard are that an ADI must:

- have an effective credit risk management system that is appropriate to its needs;
- regularly review its credit risk management systems, taking account of changing operating circumstances, activities and risks;
- have a robust system for the prompt identification, monitoring, and accurate and complete measurement of its credit risk. This includes recognition and reporting of impaired facilities and estimated future losses on the credit portfolio; and
- maintain provisions and reserves adequate to absorb existing and estimated future credit losses in its business given the facts and circumstances applicable at the time. This includes maintaining a prudent level of a General Reserve for Credit Losses.

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Authority

1. This Prudential Standard is made under section 11AF of the Banking Act 1959 (the **Banking Act**).

Application

2. This Prudential Standard applies to all **authorised deposit-taking institutions (ADIs)** other than **purchased payment facility providers (PPF providers)**, subject to paragraph 3.
3. **Foreign ADIs** must comply with the provisions in this Prudential Standard with the exception of:
 - (a) paragraphs 7(b), 8(g), 15 in so far as they relate to the General Reserve for Credit Losses, (GRCL);
 - (b) paragraphs 18(f), 20, 27, 29 in so far as they relate to provisions reported to APRA;
 - (c) paragraph 33 in so far as it relates to provisions and capital reported to APRA;
 - (d) paragraph 36 in so far as it relates to a misstatement of provisions and regulatory capital; and
 - (e) paragraphs 36(b), 36(c) 37-53 and 56-58, inclusive.

The obligations imposed by this Prudential Standard on, or in relation to, foreign ADIs only apply in relation to their Australian business.

4. A reference to an ADI in this Prudential Standard, unless otherwise indicated is a reference to:
 - (a) an ADI on a **Level 1** basis; and
 - (b) a **group** of which an ADI is a member on a **Level 2** basis.
5. If an ADI to which this Prudential Standard applies is:
 - (a) the holding company for a group, the ADI must ensure that the requirements in this Prudential Standard are met on a level 2 basis, where applicable; or
 - (b) a subsidiary of an authorised non-operating holding company (authorised NOHC), the authorised NOHC must ensure that the requirements in this Prudential Standard are met on a Level 2 basis, where applicable.

Interpretation

6. Terms that are defined in *Prudential Standard APS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.

Overview

7. Credit risk – the risk of counterparty default – usually represents the single largest risk facing an ADI. The presence of a well-functioning credit risk management system is, therefore, fundamental to the safety and soundness of an ADI. It is the responsibility of the Board of Directors (**Board**)¹ and senior management of an ADI to oversee the nature and level of credit risk which an ADI undertakes. This responsibility includes ensuring that an ADI has in place:
 - (a) credit risk management policies, procedures and controls appropriate to the complexity, scope and scale of its business; and
 - (b) internal controls to consistently determine provisions and a GRCL in accordance with the ADI's stated policies and procedures, **Australian Accounting Standards** and the requirements of this Prudential Standard.
8. An ADI's credit risk management system must include documented policies and procedures addressing the:
 - (a) monitoring of credit quality;
 - (b) identification and appropriate measurement of impaired facilities (both on- and off-balance sheet) in a timely manner (refer to Attachments A and B). 'Facilities' for the purposes of this Prudential Standard includes all loans and other financial products and services provided by an ADI to an entity that give rise to a credit exposure on the entity;²
 - (c) estimation of inherent credit risk in its business;
 - (d) recognition of collateral (including the sound and prudent valuation of security);
 - (e) write-down or write-off of uncollectible facilities;
 - (f) validation of credit assessment and provisioning and reserve processes;
 - (g) adequacy of provisions and reserves covering existing and estimated future credit losses and the timely establishment of such provisions and reserves. This includes assessment and establishment of a GRCL and provisions associated with its credit portfolio, assessed both on an individual and, where relevant, collective basis; and

¹ The requirements to be met by the Board must, in the case of a foreign ADI, be read subject to ~~paragraph 37 of~~ *Prudential Standard CPS 510 Governance* (CPS 510), which requires a foreign ADI to nominate a senior officer (whether a director or senior executive) outside Australia with delegated authority from the Board who will be responsible for overseeing the Australian branch operation.

² This includes persons, unincorporated enterprises and related entities.

- (h) production of data and other information required for adequately assessing the credit risk exposure of the ADI, including levels of impairment, accounting for asset impairment and reporting to APRA.

These policies and procedures must reflect the frameworks outlined in Attachments A, B and C as appropriate.

- 9. An ADI must regularly review its credit risk management system, including measures of credit risk exposures, taking account of changing operating circumstances, activities and risks that it may face. An ADI must inform APRA immediately of any concerns that it has about the overall level of its credit risk where this has the potential to impair the capital adequacy of the institution.
- 10. A robust system for the prompt identification of sources of credit risk and an accurate and complete measurement of such risk is at the heart of any good credit risk management system. The system must provide for a consistent approach to measurement of credit risk, including when questions arise as to the value of facilities and collateral held and as to the ultimate collectibility of an ADI's credit exposures to entities.
- 11. As part of its credit risk management system, an ADI may manage facilities on an individual and portfolio basis and, in accordance with Australian Accounting Standards, may assess provisioning in a similar fashion. An ADI's credit risk management system must address the basis upon which facilities are managed and assessed for provisioning (refer to Attachment B).
- 12. It is expected that facilities representing more significant levels of potential credit losses for an ADI will be managed on an individual basis rather than on a portfolio basis.

Scope

- 13. This Prudential Standard applies to facilities that are managed on an individual basis and those that are managed on a portfolio basis. It also covers provisions for facilities whether assessed on an individual or portfolio basis (the latter referred to as collective provisions).
- 14. This Prudential Standard does not apply to assets securitised, transferred or originated into securitisation vehicles that meet APRA's operational requirements for regulatory capital relief in *Prudential Standard APS 120 Securitisation* (APS 120) and for which the ADI is seeking capital relief.

Credit risk monitoring

- 15. An ADI's credit risk management policies, procedures and controls must provide for the systematic and regular monitoring of the credit risk to which it is exposed. Such policies and procedures assist the Board and senior management of an ADI in obtaining, on a regular basis, a view of trends and other changes in the overall nature and levels of credit risk which the ADI faces, and in assessing the adequacy of provisions, GRCL and capital that an ADI holds.

16. An ADI's credit risk monitoring must include measures to:
 - (a) enable the ADI to understand the current financial condition of an entity which is party to a facility provided by the ADI;
 - (b) monitor compliance with existing covenants attached to facilities provided by the ADI;
 - (c) assess, where applicable, the value of collateral held and the collateral coverage relative to an entity's current condition;
 - (d) identify contractual payment delinquencies and classify potential problem facilities on a timely basis;
 - (e) consider the impact of the use of the fair value on an entity's financial results (eg earnings, capital and analytical ratios) and whether this may have a material bearing on the ADI's assessment, on a continuing basis, of the credit status of an entity, where entities make a significant use of fair value (as applied under Australian Accounting Standards); and
 - (f) ensure prompt application of appropriate remedial management actions.
17. The level and intensity of monitoring should reflect the impact of potential credit exposures, both individually and aggregate of facilities, on the earnings and capital of the ADI.
18. An ADI's credit risk monitoring system must produce, as a minimum, timely and accurate information on:
 - (a) past due facilities;
 - (b) facilities that are impaired (refer to Attachment A);
 - (c) the fair value (updated at appropriate intervals) of security held against impaired facilities;
 - (d) the status (updated at appropriate intervals) of other sources of cash flows upon which an ADI might be reliant in determining incurred or estimated future credit losses on facilities;
 - (e) estimated future credit losses reflecting the inherent credit risk in its business; and
 - (f) the value of specific provisions and GRCL recorded for capital purposes.
19. An ADI must have policies and procedures to ensure timely responses to identified material changes in its credit risk profile. As part of its credit risk management system, the ADI must establish criteria for identifying and reporting to senior management and the Board those credit exposures deemed to be a source of concern. The criteria must be approved by the Board. Such criteria would be used as a trigger to consider whether to change the pattern and frequency of monitoring of such credit exposures, to undertake corrective

actions or to change levels of provisioning and capital held against potential losses.

20. The adequacy of systems established by an ADI for the identification and monitoring of its credit risk exposure is also important in providing a history of default and loss experience relevant to determining the level of a GRCL.
21. Policies, procedures and controls governing credit risk monitoring must be commensurate with the scope, scale and complexity of the business undertaken by an ADI. As the scope, scale and complexity of an ADI's business grows, the ADI must implement a more sophisticated approach towards the monitoring of its credit risk profile attuned to its increasing risk exposure. This would include a systematic classification and monitoring of its credit profile by level of risk.
22. APRA expects that the credit risk management system of an ADI with more substantial and complex credit risk exposures would include a well-structured credit-risk grading system, approved by the Board and notified to APRA. Such a system would include risk grading all credit exposures and regular review of such gradings including whenever relevant new information is received. Smaller exposures that are homogeneous and have similar risk characteristics, such as housing loans, credit cards, leases and hire purchase may, however, be grouped and be risk graded on a portfolio basis (refer to Attachment D).

Recognition of impaired facilities

23. An ADI must have policies and procedures to ensure the timely and reliable recognition of impaired facilities (refer to Attachment A) incorporating, as appropriate, the exercise of experienced credit judgement (refer to Attachment B). Such policies and procedures must provide a documented analytical framework approved by the Board for assessing impairment. This must incorporate policies and procedures to:
 - (a) identify facilities that are impaired;
 - (b) determine whether facilities are assessed for impairment on an individual or collective basis;
 - (c) determine how the amount of any impairment is measured (refer to Attachment B); and
 - (d) provide for review of amounts of impairment of facilities and methodologies used in calculating measures of impairment.

Policies and procedures must be applied on a consistent basis.

24. Impaired facilities for capital and other APRA purposes include any facility (on- or off-balance sheet) where there is doubt over the timely collection of the full amount of cash flows contracted to be received by the ADI (refer to Attachment A).
25. For the purposes of paragraph 24, doubt will exist with respect to a facility (on- or off-balance sheet) where there is objective evidence of impairment of the

facility as a result of one or more events that have occurred and that have an impact on the cash flows from the facility that can be reliably estimated. In such circumstances, the estimated cash flows will fall short of the full amount of the cash flows contractually due to be received.

26. For the purposes of paragraph 24, the existence of the following factors will, as a minimum, constitute doubt and require a facility (on- or off-balance sheet) to be regarded as impaired:
- (a) a facility is 90 days past due³ unless otherwise well-secured;
 - (b) an entity to which facilities have been provided is subject to administration or bankruptcy proceedings, unless the facilities are otherwise well secured;
 - (c) a write-off has been taken on a facility even if the facility is not in breach of contractual requirements. This does not apply in the case of some restructured facilities and assets acquired through enforcement of security; and
 - (d) with respect to off-balance sheet facilities, the ADI is unlikely to receive timely payment of the full amounts which it has exchanged or is contracted to advance.
27. Where a facility has been identified as impaired (on an individual or collective basis), an ADI must raise provisions⁴ to cover any potential shortfall in cash flows contractually due to be received (refer to Attachment B). This includes the impact of any fees due and expenses incurred in generating potential cash flows. These provisions must be excluded from Common Equity Tier 1 Capital.
28. Facilities where the original contractual terms have been modified to provide for concessions of interest or principal or other payments due, or for an extension in maturity for a non-commercial period for reasons related to the financial difficulties of an entity, must be treated as a restructured facility for the purposes of this Prudential Standard. If the facility in question does not meet at least one of the criteria in Attachment A, it cannot be treated as a restructured facility and must be recognised as impaired.

Measuring impairment of facilities

29. In order to have an acceptable measure of impairment for reporting to APRA, an ADI must have policies and procedures, approved by the Board, which provide for prudent and realistic measures of the impairment of facilities incorporating, as appropriate, the exercise of experienced credit judgements and valuation of collateral (refer to Attachment B). Such measures must incorporate estimates of future cash flows (including principal and income) from affected facilities. The policies and procedures must ensure that provisions reported to APRA by the

³ Arrears of contracted cash flows on a facility are not a necessary precondition for recognition of impairment.

⁴ Such provisions may include allowances for credit losses or impairment.

ADI are maintained at levels so that facility values, earnings and capital appropriately reflect the quality of the ADI's credit portfolio.

30. The adequacy of measures of impaired facilities must be reviewed at regular intervals and be subject to independent oversight.
31. As part of its measurement of impairment, an ADI must have policies and procedures to ensure the reliability, consistency and prudence of estimates of future cash flows, including income and principal payments, used in determining the level of impairment of facilities. Estimates of future cash flows that do not meet these requirements must be set to zero. Whenever estimates of future income flows on a facility are set to zero, or an ADI otherwise suspends interest or other income from facilities, the facilities must be reported as non-accrual facilities, for the purposes of this Prudential Standard.
32. An ADI must have policies and procedures for establishing, recording and reviewing the value of collateral held against facilities provided to entities. This includes the valuation of any security held. These policies and procedures must include as a minimum:
 - (a) the acceptability of various forms of collateral and the circumstances in which it may be used;
 - (b) the valuation of collateral prior to entering into any facility and over the life of the facility. Valuation, and reviews of valuation over the life of a facility, must be conducted on a prudent basis and have regard to the time, costs and difficulties involved in generating payments through access to collateral; and
 - (c) procedures for ensuring that the collateral is, and continues to be, enforceable and realisable.

The policies and procedures must be linked to the ADI's credit assessment, approval and management process. They must provide for a consistent application across the ADI.

33. The timing and intensity of review of collateral values must have regard to the reliance placed on collateral values in estimating future cash flows. It is the responsibility of the Board and senior management of an ADI to ensure that where the value of collateral materially underpins estimates of future cash flows and, hence, measurements of impairment, provisioning and capital reported to APRA, the values of collateral used are timely, reliable and the ADI's access to collateral is assured.
34. For the purposes of this Prudential Standard, all assets taken as security by an ADI must be valued, wherever possible, at their fair value (refer to Attachment A). Fair values must take account of the costs of accessing and selling security, including any taxation liabilities attributable to an ADI, and any other uncertainties relevant to the value of the security (refer to Attachment B).

35. Reliance on collateral must not:
- (a) be a substitute for an appropriate assessment of a party to a facility, in particular, the party's ability to meet its contractual obligations; or
 - (b) compensate for insufficient information about a party.
36. Where APRA assesses that the practices being applied by an ADI to the recognition and valuation of collateral may result in an inappropriate recognition of collateral, and consequently a misstatement of provisions and regulatory capital or which otherwise may reflect adversely on the safety and soundness of an ADI, APRA may exercise its powers⁵ to:
- (a) require an ADI to adjust its valuation methodologies or practices;
 - (b) increase levels of provisioning reported to APRA; or
 - (c) hold higher levels of capital.

Provisioning, estimated future credit losses and the General Reserve for Credit Losses

37. An ADI must report specific provisions and a GRCL that, together, are adequate at all times to absorb credit losses in the ADI's business, given the facts and circumstances applicable at the time (refer to Attachment B). This includes losses identified as being incurred and incurred-but-not-yet-reported, as well as credit losses estimated but not certain to arise in the future, as a result of the inherent credit risk in the ADI's business extending over the life of all the individual facilities making up its credit risk portfolio.
38. It is the responsibility of the Board and senior management of an ADI to ensure that assessments of the level of impaired facilities and estimated future credit losses, specific provisions including any prescribed provisions and the GRCL reported to APRA are prudent and reasonable.
39. In accordance with Australian Accounting Standards, ADIs may assess provisions on an individual facility basis or on a collective basis. For the purposes of this Prudential Standard, collective provisions raised by an ADI must be classified as either specific provisions or as part of the GRCL.
40. An ADI's specific provisions and the GRCL must account for all significant factors as at the evaluation date that affect, as relevant, the collectibility of the credit portfolio and estimated future credit losses. The levels of specific provisions and the GRCL must be reviewed regularly to ensure that they are consistent with identified and estimated losses.
41. In all cases, policies and procedures applied to the assessment and reporting of impaired assets, specific provisions and the GRCL must be rigorous and

⁵ Refer to section 11CA of the Banking Act.

appropriate to the risks involved and must generate adequate provisioning and reserve outcomes. Where APRA considers that:

- (a) the policies and procedures applied;
- (b) the levels of impaired assets and estimated credit future losses, specific provisions and the GRCL reported by an ADI; or
- (c) the consequential level of an ADI's earnings and capital adequacy reported to APRA

do not meet the requirements of this Prudential Standard, or may adversely reflect on the measurement of an ADI's capital adequacy or its safety and soundness, APRA may seek to exercise powers⁶ available to it to require an ADI to adopt amended or alternate policies and procedures; to increase the amounts of impaired assets, specific provisions and GRCL; or to otherwise increase its capital.

Specific provisions

42. For the purposes of this Prudential Standard specific provisions include:
- (a) all provisions for impairment assessed by an ADI on an individual basis in accordance with Australian Accounting Standards;
 - (b) that portion of provisions assessed on a collective basis in accordance with Australian Accounting Standards (i.e. collective provisions) which are deemed ineligible to be included in the GRCL; and
 - (c) any provisions not already charged against profit and loss which an ADI is required to recognise as a specific provision in accordance with this Prudential Standard. This includes any provisions held against off-balance sheet facilities which are required to be treated as impaired facilities (refer to Attachment A) and prescribed provisions as reported in accordance with Attachment C.
43. The level of provisions reported by an ADI under Australian Accounting Standards, whether assessed on an individual or collective basis, may not be sufficient to provide the level of provisions which an ADI needs to hold to meet the specific provisioning requirements in this Prudential Standard. In these circumstances, the ADI must create the required amount of specific provisions and reduce its Common Equity Tier 1 capital by the amount of the additional specific provisions (refer to Attachment B).
44. Unless APRA agrees otherwise, in writing, an ADI must establish and apply its own policies and procedures for determining impairment of facilities and associated provisions relying on its own methodologies, supported by robust internal controls and in accordance with Australian Accounting Standards.

⁶ Refer to section 11CA of the Banking Act.

45. Where APRA considers that a simple overall approach to determining specific provisions is acceptable for measuring the capital adequacy of an ADI, or APRA judges an ADI's own practices for identifying specific provisions to be inadequate in view of its credit risk profile, APRA may permit, or require, an ADI to implement the prescribed provisioning approach described in Attachment C.

Collective provisions

46. For the purposes of this Prudential Standard, an ADI must classify its collective provisions into
- (a) specific provisions; or
 - (b) a GRCL.
47. Depending on the form of collective provisions raised, all, some, or none of such provisions may be included in the GRCL. An ADI's policies and procedures must address how such classification is to be undertaken.
48. A collective provision raised by an ADI under Australian Accounting Standards that is not eligible to be included in the GRCL must be reported as a specific provision. The remaining eligible portion of an ADI's collective provisions raised in accordance with Australian Accounting Standards must be included in the ADI's GRCL.
49. That portion of collective provisions covering facilities where any assessment of probability of default or loss would give rise to a reasonable expectation that the facilities in question will need in the short term to be subject to:
- (a) a write-down or write-off; or
 - (b) assessment for impairment on an individual facility basis
- must be treated as specific provisions for the purposes of this Prudential Standard.
50. Factors contributing to a reasonable expectation include but are not limited to:
- (a) the extent and period of non-compliance of facilities with their contractual terms;
 - (b) the likelihood of facilities which are not well secured being subject to administration or bankruptcy proceedings;
 - (c) internal or external credit ratings suggestive of a substantial increased risk of potential default or loss;
 - (d) adverse data about a particular industry or a country exposure suggestive of a substantial increased risk of potential default or loss in the short term, even though no individual facility is identified as likely to be involved; or

- (e) possible losses arising in the short term from changes in economic conditions.⁷
51. Where an individual facility included in a group of facilities is subject to collective assessment and the facility is individually assessed as impaired, the individual facility must be removed from the group. Following this, any collective provisions incorporating the individual facility concerned must be redetermined prior to an ADI assessing what portion of its collective provisions are eligible to be included in a GRCL.
52. Where a collective provision relates to possible losses from facilities in a group of facilities and:
- (a) the losses are expected but not certain to arise; and
 - (b) the facilities are currently meeting their contractual terms (e.g. they are not past due more than 90 days),
- the provision is eligible to form part of the GRCL.
53. In the event that APRA considers the policies and procedures established by an ADI do not produce an acceptable classification of collective provisions into specific provisions and the GRCL, APRA may seek to exercise powers available to it to require an ADI to adopt amended policies and procedures; to change amounts reported to APRA in the GRCL and specific provisions; or to otherwise increase its capital.

Estimated future credit losses over the life of a portfolio

54. An ADI must have a clear and comprehensive understanding of the credit risk inherent in its business. Where an ADI undertakes new business activities it must consider from the outset the type and level of credit risk to which such activities may give rise and the impact this has upon the inherent credit risk in the ADI's business.
55. Unless otherwise agreed with APRA, in writing, an ADI must undertake an assessment of the credit losses that are prudently estimated but not certain to arise in the future over the full life of all individual facilities which make up the business of the ADI. Such estimated future credit losses reflect the credit risk inherent in the ADI's business. All facilities must be covered notwithstanding that there may be no doubt about the full collection of future cash flows on such facilities at the current time. Estimated future credit losses on facilities may be adjusted to account for any impairment already recognised in specific provisions and capital of the ADI.

⁷ For example, where an ADI raises a collective provision reflecting expectations that, because of a downturn in a particular industry, there is a likelihood of greater than expected losses on its portfolio of loans in that industry in the immediate future, this collective provision must be treated as a specific provision for the purposes of this Prudential Standard. This is notwithstanding that potential losses have not been attributed to any particular borrowers.

General Reserve for Credit Losses

56. Irrespective of the approach applied by an ADI to determining provisions in accordance with Australian Accounting Standards, an ADI must maintain, unless APRA otherwise agrees, in writing, a GRCL (refer to Attachment C to *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* and Attachment B to this Prudential Standard). A GRCL represents a reserve established under this Prudential Standard that, as a minimum, covers credit losses prudently estimated but not certain to arise over the full life of all the individual facilities making up the business of the ADI (refer to Attachment B). For these purposes, the GRCL must be reported gross of after-tax effects. The GRCL must be freely available to meet any credit losses that subsequently materialise and must also be determined on a portfolio basis.
57. An ADI must report a level of GRCL sufficient to cover its estimated future credit losses. However, where APRA, having regard to the complexity, scope and scale of an ADI's business, considers that an alternative approach to determining the level of the General Reserve for Credit Loss is preferable, APRA may, in writing, require the ADI to report the GRCL in accordance with that approach.
58. In the event that:
- (a) an ADI has not created a GRCL from a charge on, or an appropriation of, profits in its audited published financial reports; or
 - (b) has recorded a GRCL below that which it is required to hold in accordance with this Prudential Standard

the ADI must deduct from its **Common Equity Tier 1 Capital** any additional amount it is required to report in its GRCL. This is only to the extent that such an amount has not already been charged or appropriated against its profits (e.g. that portion of collective provisions raised by an ADI which are eligible to be included in a GRCL).

Prudential oversight of foreign ADIs

59. As part of its prudential oversight of the Australian operations of a foreign ADI, APRA may discuss with the foreign ADI's parent and home supervisor the foreign ADI's credit management systems, including the level of impaired facilities and estimated future credit losses that exist in the Australian business. These discussions may also include the level, type and adequacy of credit loss provisioning and reserves which the foreign ADI may have established in relation to its Australian business.

Attachment A

Impaired Facilities

Scope

1. The appropriate recognition and measurement of impaired facilities (e.g. assets) are key elements in the accurate reporting of an ADI's risk profile, in the assessment of the adequacy of an ADI's provisioning and reserving policies and, most importantly, in the assessment of its capital adequacy.
2. The scope of impaired facilities must cover the full range of an ADI's activities. In classifying impaired facilities, an ADI must not limit itself to lending activities but must cover all other financial products and services provided by the ADI to an entity which give rise to a credit exposure to the entity.
3. Where an ADI is not required to hold regulatory capital against the value of any impaired assets sold, transferred or originated into a securitisation vehicle in accordance with APS 120, such assets must not be included in an ADI's reported impaired facilities. However, where securitised assets do not meet APRA's operational requirements for regulatory capital relief, these assets must be captured, as appropriate, in the reporting of impaired facilities.

Policies and procedures for recognition of impaired facilities

4. Factors that affect the collectibility of facilities include, but are not limited to:
 - (a) indications of significant financial difficulty of a party to a facility; or
 - (b) breach of contract, such as a default or delinquency in interest or principal; or
 - (c) the likelihood of bankruptcy or other financial reorganisation of a party to a facility; or
 - (d) concessions in terms of a facility (e.g. interest or principal payments) granted to a party to a facility relating to such a party's financial difficulties; or
 - (e) changes or trends in default rates on categories of facilities which might be assessed for impairment on a collective basis; or
 - (f) any identified changes in the value of collateral or other sources of security which might bear on the collectibility of facilities; or
 - (g) disappearance of an active market in assets (including derivatives) held by an ADI relating to a given counterparty; or
 - (h) any other matter which might reasonably suggest to an ADI that a party to a facility may be unlikely to meet its contractual obligations.

5. Recognition and measurement of impairment in practice cannot be based totally on formulas or rules. Assessment of the level of impairment on a facility will often require a mix of documented sound policies and procedures and the application of experienced credit judgement by management of an ADI. The scope for the exercise of discretion in assessing impairment must be prudently limited and documentation must be in place to enable an understanding of the procedures and judgements which are exercised by management.
6. The policies and procedures applied to the recognition of impaired facilities must be appropriate to the complexity, scope and scale of business undertaken by an ADI. In determining the timing and intensity of the review of facilities for impairment, an ADI may have regard to the cost of assessing impairment vis-à-vis the size of facilities and the impact of any non-recognition of impairment on earnings and capital reported to APRA (refer to Attachment B).⁸

Definition of impaired facilities

Overall definition

7. A facility must be classified as impaired regardless of whether it is 90 days or more past due, when there is doubt as to whether the full amounts due, including interest and other payments due, will be achieved in a timely manner. This is the case even if the full extent of the loss cannot be clearly determined. Such a requirement applies particularly to the range of flexible financing facilities common in the Australian financial system, including loans where repayment of principal and interest occurs only as a single payment at maturity; and also to large money market transactions where doubt about collectibility arises immediately in the event that settlement does not eventuate.
8. Overdrafts and other revolving facilities that have remained continuously outside approved limits (including unadvised internally authorised excesses or extensions approved as part of the initial credit extension process) for 90 or more consecutive days, and which are not well-secured, must be treated, for the total amounts outstanding, as impaired. This 90-day threshold must also be applied to unadvised limits approved as part of the normal credit extension process.
9. Where an advised limit applied to overdrafts and other revolving facilities has been increased to accommodate higher business demand of a sound entity⁹, the facility need not be regarded as impaired provided, after appropriate internal review, an ADI is satisfied that the entity can meet its obligations under the higher limit.

⁸ While non-recognition of impairment on a small individual facility may have minimal impact on capital of an ADI, non-recognition of impairment on a substantial number of like facilities may have a marked impact on reported capital.

⁹ This includes persons and unincorporated enterprises.

Multiple facilities

10. An ADI must treat entities as related where there is:
 - (a) a linkage by cross-guarantees;
 - (b) common ownership or management;
 - (c) ability to control;
 - (d) financial interdependency; or
 - (e) other connections which, in the ADI's assessment, would lead it to regard facilities it has provided to the various entities as representing a common risk.
11. ADIs are not required to treat facilities provided to family members involving retail financial products as related for the purposes of this Prudential Standard, provided an independent financial relationship exists amongst the family members concerned.
12. Where an ADI has multiple facilities to a single entity or a group of related entities, the ADI must have policies and procedures to ensure that if one facility is assessed as impaired, consideration is given to whether it would be prudent to classify the remainder of the facilities as impaired. Extension of the impairment classification is not required if:
 - (a) the various facilities are not cross-collateralised, and there are no cross guarantee arrangements between the related entities; or
 - (b) there are cross-collateral and guarantee arrangements but, in aggregate, there is sufficient security among the group of related entities to ensure ultimate collectibility of all principal and interest on both the impaired and performing exposures.

Treatment of off-balance sheet exposures

13. The principal off-balance sheet facilities captured by this Prudential Standard are direct credit substitutes and commitments. Direct credit substitutes (e.g. guarantees and standby letters of credit) are usually converted into on-balance sheet exposures when they are drawn. However, there may be circumstances when an ADI is reasonably certain that such instruments will be called upon at a future date because of uncertainty about the financial standing of the entity which they support, and there may also be cause to believe that the ADI may not be able to recoup, in a timely manner, the full amounts it may be required to advance. In such cases, the facilities in question must be regarded as impaired.
14. Loan commitment facilities that are irrevocable must also be classified as impaired facilities if the creditworthiness of an entity has deteriorated to an extent that the timely repayment in full by the entity of any potential loan drawdown or associated interest payments or fees is in doubt. An amount

recognised for impairment would have regard to estimates of likely drawings on facilities and the ultimate collectability of such amounts.

15. Exposure to potential losses arising from facilities such as derivative transactions, especially long-term derivative transactions, may arise if the credit standing of an entity that is the counterparty in such facilities declines. If an ADI has doubts regarding the receipt, in full, in a timely manner, of cash flow entitlements which are or will be due from a counterparty to a derivative transaction, it must treat such an exposure as impaired. In this regard, ADIs must calculate their derivative transaction exposures to counterparties for purposes of measuring impairment (and provisioning) using the current exposure or *mark-to-market* method (refer to Attachment B of *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112)*), or a method approved in advance by APRA. Potential exposure *add-ons* applied in calculating such exposures must reflect the nature of the individual facility involved. Derivative transaction exposures must be revalued regularly so as to maintain reasonably current assessments of the extent of credit risk attaching to these transactions.

Matters bearing on the recognition of impairment

16. A facility subject to a regular repayment schedule is regarded for the purposes of this Prudential Standard as 90 days past due when:
 - (a) at least 90 calendar days have elapsed since the due date of a contractual payment which has not been met in full; and
 - (b) the total amount¹⁰ unpaid outside contractual arrangements is equivalent to at least 90 days worth of contractual payments.
17. A facility will remain outside contractual arrangements notwithstanding any waiver of payments unless such a facility has been formally restructured.
18. A loan with a monthly repayment schedule will be 90 days past due three months from the time when the initial payment was due but not made. Facilities that do not have a contractual repayment schedule (e.g. overdrafts and revolving credit facilities) are considered 90 days past due where the facilities have remained continuously outside initially approved arrangements (i.e. 90 consecutive days, including any temporary excess approvals).
19. For the purposes of this Prudential Standard, fair value is defined under Australian Accounting Standards. If there is a range of possible fair values, the smallest value of the range of possible values must be used. Where fair value refers to the value of collateral or other forms of security held covering a facility, the fair value must have regard to the projected costs of obtaining and selling the security, whether or not realisation of the security is considered probable.

¹⁰ This includes all fees and any charges that are due but unpaid as a result of missed payments.

20. A well-secured facility is, for the purposes of this Prudential Standard, defined as one where an ADI judges that:
- (a) the value of collateral (including the fair value of associated security) is sufficient to ensure that the ADI will recover the outstanding principal¹¹ and other previously unpaid amounts, and any estimated shortfall in all remaining cash flows (e.g. payments) due over the life of the facility. This includes any amounts arising over the period until collateral is obtained and settled. Collateral includes any arrangement that protects the ADI from losing, partially or fully, the principal, interest or other amounts due on a facility. This will include secured interests in assets, mortgage insurance, cash collateral, guarantees, put options and interest servicing arrangements. An ADI must be able to demonstrate to APRA, if required, that any value ascribed to collateral (including, in particular, security) is reliable in a recovery situation (refer to Attachment B); and
 - (b) there is reasonable assurance that collection efforts will result in payment of amounts due in a timely manner (including full compensation for overdue payments).
21. In determining whether the coverage provided by collateral will enable an ADI to recoup all cash flows due¹² over the life of the facility, the ADI must take account of any costs (e.g. selling costs) involved in taking possession of and realising the value of collateral.

Restoring facilities to non-impaired status

22. For a facility classified as impaired to be restored to non-impaired status for the purposes of this Prudential Standard, at least one of the following conditions must be satisfied:
- (a) a facility has returned to being fully compliant with its original contractual terms (including receipt by the ADI of all past due principal and interest payments);
 - (b) a facility has been formally restructured and meets the criteria required for such a facility to be treated as non-impaired;
 - (c) for a facility which has been classified as impaired because of arrears past due 90 days, all unpaid amounts have been reduced to below the dollar equivalent of 90 days' worth of contractual payments, provided the payment of arrears has not resulted from a further advance by the ADI. Alternatively, the facility may be reasonably considered to be well-secured. For facilities where interest is capitalised under the presumption that security will also cover the payment of these amounts, ADIs must satisfy themselves on current estimates that there is a margin of comfort

¹¹ This includes any previously due but unpaid interest, fees, etc.

¹² This includes any outstanding payments due but not yet received.

which would prevent facilities (including any capitalised interest) from slipping back to impaired status in the foreseeable future;

- (d) for a facility classified as impaired as a result of write-offs, the facility has been fully performing for six months (or three payment cycles¹³, whichever is greater); or
 - (e) for a facility subject to a specific provision prescribed in accordance with the requirements of this Prudential Standard, the provisions are no longer applicable to the facility.
23. In order for a facility classified as impaired to return to non-impaired status, an ADI must also in all circumstances:
- (a) have formed a view that the entity is capable of fully servicing all its future obligations in a timely manner under the facility or the ADI will otherwise receive the full amounts due in a timely manner as a result of access to collateral covering the facility;¹⁴ and
 - (b) no longer maintain a provision assessed on an individual basis against the facility.
24. Underlying evidence must support the view that there is no doubt about an entity meeting its future obligations. Such evidence must be appropriately documented in a written assessment that addresses the current credit evaluation of the entity's financial condition and other factors affecting prospects for repayment which may have lead to an assessment of a facility as impaired.
25. For revolving facilities which are not well secured, drawings must have returned within approved limits for a facility to return to non-impaired status. Any clearance which an ADI considers is undertaken merely to 'reset' the past due status of a facility must not be recognised for purposes of assessing the past due status of facilities for impairment purposes.

Restructured facilities

Definition

26. A restructured facility is defined for the purposes of this Prudential Standard as a facility in which the original contractual terms have been modified to provide for concessions of interest, or principal, or other payments due, or for an extension in maturity for a non-commercial period for reasons related to the financial difficulties of an entity.

¹³ This refers to the period of time for contractual payments. For example, three payment cycles for interest paid quarterly will refer to three times three months or nine months in total.

¹⁴ This covers the return of off-balance sheet facilities classified as impaired – i.e. an ADI can return such facilities to a non-impaired status where the ADI has formed a belief that it is likely to receive in a timely manner the full amounts of cash flows due to it under such facilities (e.g. repayment of amounts of funds which it might be called on to advance under a guarantee).

27. Any of the following concessions lead to a facility being classified as restructured:
 - (a) a reduction in the principal amount of the facility, or the amount payable at maturity, as set down in the original loan agreement;
 - (b) an interest rate below the terms originally contracted;
 - (c) a reduction of accrued interest, including forgiveness of interest;
 - (d) a deferral or extension of interest or principal payments, including interest capitalisation;
 - (e) an extension of the maturity date or dates at a stated interest rate lower than the current market rate for new facilities with a similar risk; or
 - (f) an extension of the maturity date or dates materially beyond the maturities that would be offered to new facilities with similar risk.
28. For a facility to be classified as restructured, the ADI and the entity which is party to the facility must formally agree to the new terms. In the event that the new terms are not subject to a formal agreement, a facility must be treated as impaired.
29. A facility which is extended or renewed on terms in line with those which would be offered at that time to new clients with similar risk profiles, and where such extension or renewal does not flow from any financial difficulties of an entity, is not considered a restructured facility for the purposes of this Prudential Standard.
30. An ADI must have in place policies to identify, monitor and manage restructured facilities. Any restructuring of a loan or other facility must be supported by a current, well-documented credit assessment of the entity's financial condition and prospects for repayment under the modified terms. Renegotiation of a facility must not be used to obscure the poor quality of a facility's performance, or avoid its recognition as impaired and in turn reduction in Common Equity Tier 1 capital. Before any concession is made to an entity, the appropriate level of management must approve the restructured facility.
31. Restructurings required under the provisions of the National Credit Code that satisfy the concessions in this Prudential Standard are also included in the definition of restructured items.
32. A non-National Credit Code regulated facility must not be reported as a restructured item where it is placed on restructured terms for less than twelve months due to temporary financial difficulty being experienced by the entity but where long-term viability is unquestioned (e.g. a rural facility encountering a bad season). Such a facility may be treated as non-impaired. The ADI must, however, be reasonably confident that the entity is able to fully perform with no loss of principal and the originally contracted amount of interest or other payments due, and the ADI must not maintain any provisions assessed against the facility on an individual basis.

Treatment of restructured facilities

33. Where a facility has been restructured, the value of the facility for capital purposes must be reduced to fully reflect, at the date of restructuring, the effect of any reduction in cash flows previously due under contracted terms. Such change in value must be implemented by way of adjustment to the Common Equity Tier 1 Capital of the ADI.
34. Provided an appropriate adjustment has been made to the value of a facility, if a facility is restructured so that all of the following requirements are satisfied:
 - (a) an ADI expects the entity will perform on the restructured terms so that it will receive in a timely manner the full amount of cash flows now contracted to be received or is otherwise well secured;
 - (b) the restructured facility yields an effective rate of return equal to or greater than the effective rate of return which could be earned at the date of restructuring on other new facilities of similar risk;
 - (c) any other restructured terms are considered by the ADI as similar to those applicable to new facilities with similar risk;
 - (d) the restructured facility has operated in accordance with the restructured terms and conditions for a period of at least six months or three payment cycles, whichever is longer; and
 - (e) no provisions remain assessed against the restructured facility on an individual basis,

the facility can be returned to a non-impaired status for the purposes of this Prudential Standard. If a restructured facility does not satisfy all of the above requirements, it must continue to be treated as impaired.

35. A single facility cannot be split into impaired and non-impaired parts in the absence of a formal restructuring agreement. In these circumstances, if a facility cannot support all cash flows the whole facility must continue to be regarded as impaired.
36. In certain circumstances, sufficient evidence may exist to demonstrate relative improvement in the condition and debt service capacity of an entity, apart from performance to date, which would warrant return to non-impaired status prior to the six-months (or three payments cycles) threshold. This might include the signing of lease or rental contracts, or an equity injection. Where this occurs, an ADI may return the facility to non-impaired status for the purpose of reporting to APRA, provided the other requirements specified in paragraph 34 in this Attachment are satisfied.

Assets acquired through security enforcement (including other real estate owned)

37. These are defined as assets (both real estate and other physical assets) acquired by an ADI in full or partial settlement of a loan or similar facility through enforcement of security arrangements. This category excludes mortgagee in possession assets (both real estate and other physical assets). Assets reported in these categories must be recorded for the purposes of this Prudential Standard in accordance with their fair values. In determining fair values, an ADI must pay particular regard to considerations such as market liquidity and disposal costs.

Past due facilities

38. Past due facilities are one consequence of the business of extending credit. APRA considers that a greater risk of default attaches to past due facilities than to those facilities maintained in accordance with contractual arrangements. ADIs are expected to have in place appropriate systems to adequately manage past due facilities with a view to minimise the migration to impaired asset status. An ADI must, therefore, be able to identify, monitor and regularly report to APRA as required, the performance of past due facilities, including importantly, those facilities not required to be treated as impaired assets.

Income recognition

39. Upon the initial recognition of an impaired facility, a provision must be created by way of a charge against profit and loss (and, in turn, Common Equity Tier 1 Capital).
40. Where a provision has been established as the difference between the carrying amount of an impaired facility and the discounted estimated future cash flows on the facility (refer to Attachment B), an unwinding of the discount arising from the passage of time may be included in Common Equity Tier 1 Capital.

Attachment B

Impairment, Provisioning and the General Reserve for Credit Losses

1. The adequacy of the level of provisioning and reserves established by an ADI against potential credit losses is a significant element in the assessment of its capital adequacy.
2. Consideration of the adequacy of provisioning will depend on the reliability of the assessment of impairment of facilities. Such assessment rests on the overall soundness of credit risk monitoring (including policies, procedures and related internal controls) and the prudent exercise of experienced credit judgement.
3. Two key determinants associated with the adequacy of provisions are the prudence and soundness of the ADI's policies and procedures for:
 - (a) recognition of impaired facilities (refer to Attachment A) ; and
 - (b) measurement of impairment of facilities.

Measurement of impairment of facilities

4. In determining measures of impairment an ADI must have a realistic and comprehensive view of all of its business activities (including both on- and off-balance sheet exposures). This comprehensive view must take into account all available information on a timely basis.
5. An ADI's Board must satisfy itself that the measures of impaired facilities and, in turn, the levels of specific provisions reported to APRA are prudent and reasonable.
6. Policies and procedures covering the recognition (including measurement) of impairment of facilities, and the specific provisions which flow from such impairment, must be well documented with clear explanations of supporting analysis and rationale. Such policies and procedures must, amongst other features, address:
 - (a) the role and responsibilities of the Board and senior management in determining and monitoring the adequacy of measures of impaired facilities and, in turn, specific provisions reported to APRA;
 - (b) the basis to be used for determining whether facilities are managed on an individual or portfolio (collective) basis, and whether measures of impairment and provisions are to be assessed on an individual or collective basis. This incorporates the processes to be followed when deciding to change to assessing provisions from a collective basis to an individual facility basis;

- (c) the characteristics used to group facilities on a collective basis for purposes of managing and/or assessing provisioning;
- (d) the approach used for determining and measuring impairment of facilities managed on an individual and collective basis (refer to Attachment A);
- (e) the level and type of data and other information required to enable the ADI to meet the objectives underpinning its identification of impaired facilities;
- (f) the process for ensuring a consistent approach across the ADI, and through time, for the recognition and reporting of impaired facilities. Changes or differences in approach must be capable of being justified and must be approved at the appropriate level; and
- (g) the approaches to be followed in arrears management and the write-down and write-off of facilities.

Estimates of future cash flows

7. Under Australian Accounting Standards, a provision or allowance for credit losses reflects the level of impairment of a facility. For financial assets carried at amortised cost, impairment is calculated as the difference between the future cash flows (including both principal and interest) estimated to be collectable on a facility and the carrying amount of the facility. Reflecting the time value of money, expected future cash flows are discounted at the effective interest rate inherent in the facility. Expected future cash flows have regard to all the contractual terms of a facility including, amongst a range of factors, all sources of expected income, options and, where appropriate, the fair value of collateral which may be accessed. The value of provisions will necessarily vary over time as a result of changes in amounts of expected cash flows.
8. Reliability of estimates of future cash flows will have regard to whether:
 - (a) there is any material uncertainty regarding the receipt of cash flows in the future; and
 - (b) an ADI's systems (including timely access to relevant information regarding the credit status of an entity) are adequate to provide for reliable estimates of future cash flows.
9. Policies and procedures used by an ADI in estimating future cash flows must provide for, but are not limited to:
 - (a) estimates of future cash flows (including timing of such flows) to be documented and based on prudent and supportable assumptions;
 - (b) the capture of all available information bearing on initial estimates of impairment and relevant to updating estimates of impairment;

- (c) a framework for determining when, and how much of, estimated future income and principal cash flows will be recognised;
 - (d) a consistent basis for determining estimates; and
 - (e) an appropriate review process for estimates of cash flows (including audit). More frequent review must be undertaken where the measure of an impairment of facilities would have a material impact on the assessment of the adequacy of an ADI's provisioning and capital.
10. Estimates of future cash flows, and hence measures of impairment, must have regard to:
- (a) any information suggesting further deterioration in the ability of the party to the facility to meet contractual obligations;
 - (b) updated valuation of collateral; and
 - (c) any changes to cash flow predictions which might reasonably be expected to flow from current assessments of economic conditions.
11. Where an ADI holds no collateral covering any potential credit losses on a facility, but relies instead on sustainable cash flows from an entity's business or the existence of unencumbered assets of the entity to arrive at estimated future cash flows (and, in turn, measures of impairment and levels of specific provisions), an ADI must be able to demonstrate to APRA, if required, that it has reasonably satisfied itself that:
- (a) the entity will be able to generate the required cash flows; or
 - (b) with respect to any unencumbered assets, the assets are freely available to meet the cash flows due to the ADI from the facility; and
 - (c) any assets concerned are valued on a fair value basis (refer to Attachment A).
12. APRA recognises that the determination of the level of impairment of facilities involves the exercise of judgement. However, an ADI, if required, must be able to demonstrate to APRA that the exercise of such judgement has not led to any systemic misstatement of estimates of impairment, provisions and capital reported to APRA.

Collateral

13. Collateral is held to mitigate the risks (both identified and inherent) in individual facilities. Collateral can include guarantees, insurance arrangements and, importantly, security held over various forms of assets. Where estimated future flows of income and principal reflect collateral held against potential credit losses, the assessment of that collateral - in particular, the valuation of assets taken as security - is a significant issue in assessing the measurement of

impairment of facilities, and consequently the adequacy of the ADI's provisioning and capital.

Security valuation practice

14. An ADI must ensure that assets to be taken as security are accurately and completely identified and documented in facility documentation. The ADI's credit administration function must ensure that the relevant legal requirements are met to maintain the ADI's security position and to provide for its enforcement.
15. Valuation of security must be undertaken prior to drawdown on any facilities.
16. In the event that the fair value of security is based on observable market values, an ADI's policies and procedures must give regard to:
 - (a) when observable market prices would be used;
 - (b) the basis for selecting (where relevant) the market prices to be used;
 - (c) the impact of market liquidity on the pricing of assets and the timing of their disposal; and
 - (d) costs which would arise in accessing and disposing of assets held as security.
17. In determining the fair value of security, an ADI may utilise the valuations of suitably qualified internal appraisers or external valuers. Policies and procedures covering the fair value of security must address the circumstances in which such valuations would be sought.
18. Where an ADI uses valuations from internal appraisers, it must have policies and procedures which address:
 - (a) when valuations would be provided by internal appraisers; and
 - (b) the qualifications and experience required of internal appraisers when undertaking valuations.
19. If an ADI relies on external expertise for its security valuation needs, it must establish robust selection and review mechanisms. Factors that must be considered in the selection process include:
 - (a) professional qualifications required;
 - (b) relevant experience (including local knowledge);
 - (c) breadth of expertise to cover both standard and specialised security assessments; and
 - (d) appropriate professional insurance cover.

20. Policies and procedures must also provide for the formulation of instructions for the conduct of valuations. Each valuation request must be the subject of specific instructions to the appraiser or valuer. These instructions must cover (as relevant in each instance) appropriate issues such as valuation purpose; valuation basis required; valuation for insurance purposes; valuation method; market summary/commentary; and form of report required. Where a party other than the ADI instructs the valuer, the valuation must be appropriately endorsed for the ADI's use. Good practice in these circumstances would be to have the valuation confirmed by an internal appraiser, or an external valuer, with the appropriate expertise.
21. In the event that an ADI makes use of valuations in determining the fair value of security, the ADI must require valuers and appraisers, in preparing their valuation reports, to adopt the valuation standards and practices of any relevant professional bodies. For example, in the case of property valuations, the standards and practices of the Australian Property Institute (API) or equivalent local or offshore bodies must be used. Valuation reports must be based on the standard format advocated by any relevant professional bodies.
22. Given the importance of valuations to the estimation of the fair value of security, an ADI must have policies and procedures directed at ensuring the reliability of the valuation processes and valuations received in respect of security held. This may involve internal reviews of valuations by appropriate management or audit staff and formal reviews by an independent valuer.
23. An ADI's policies and procedures must provide for regular assessment of security values so as to ensure that the fair value of security underpinning provisioning, and any security coverage measures applied to facilities, is timely and reliably reflects values which an ADI might realise if needed. This is especially important where facilities are secured by assets that are susceptible to significant changes in value (e.g. commercial property) or where the margin for diminution of value of security is small (e.g. high loan-to-valuation loans).

Valuation of security in the form of property

24. In many instances, property is a prime source of security held by an ADI against facilities it has provided to an entity. As a result, the processes used to value property in determining the fair value of security are significant for the measure of an ADI's impaired assets, provisions and, ultimately, its capital.
25. For security held in the form of property, the timing as to when property will be accessed, and ultimately disposed of, is a crucial issue. Of particular importance in valuations is the time allocated to market a property. For purposes of determining the fair value of security involving property, an ADI must assume:
 - (a) a property would be accessed in the near future;
 - (b) the period for marketing a property would be up to 12 months, although a longer period (up to a maximum of 24 months) may be adopted for

specialised or unusual properties when professional valuers advise that this is appropriate; and

- (c) for the purposes of valuation, market conditions and thus asset values are assumed to remain static over the marketing period. To reinforce this point, marketing periods are to be assumed to have elapsed at the date of valuation (i.e. should be retrospective), thereby eliminating any possibility for improved market conditions to be factored into the valuations.
26. In determining fair values of security, property assets must, unless otherwise agreed with APRA, be valued on the basis of existing use. Any higher value related to an alternative use or 'element-of-hope' value arising from prospects of redevelopment, and any possible increase in value consequent upon special investment or finance transactions, must be disregarded. In determining values based on 'existing use', care must be exercised in imputing future income streams (e.g. lease payments) which are not already contracted.
27. In some circumstances, it may be difficult to determine the fair value of property assets (e.g. new properties) that have not yet achieved a stable income, or properties that are experiencing drastic fluctuations in income. In such cases, a forecast of expected cash flows must be used to estimate the value of the property. The discount rates used in calculating the value of security must reflect the opportunity cost (determined by way of comparison with prevailing returns on competing investments) of holding the property, assuming a long-term holding. Capitalisation rates must reflect expectations about the long-term rate of return investors require under normal, orderly and sustainable market conditions.

Valuation of security in the form of non-real estate assets

28. Where collateral held takes the form of a charge over non-real estate assets, for example, fixed and floating charges and debenture mortgages over the assets, or guarantees or cross-collateralisation arrangements involving third parties, an ADI must ensure that all relevant collateral is properly scrutinised.
29. Where an entity to which an ADI has provided a facility supplies information relating to the security which the ADI holds on the facility (e.g. outstanding debtors), asset values must be objectively assessed to ensure security coverage is adequate. This may include testing of information supplied.
30. In determining the fair value of those classes of security comprising non-real estate assets, an ADI must also have regard to considerations such as market liquidity, legal costs, impediments to realisation and prior charges.

Provisioning and reserving for credit risk practices

Policies and procedures

31. An ADI's provisioning and reserving policies and procedures must:
- (a) cover provisions assessed on an individual basis and any provisions assessed on a portfolio (or collective) basis;
 - (b) address the relationship between estimates of impairment of facilities and the level of specific provisions reported;
 - (c) include reporting of estimated future credit losses and a GRCL;
 - (d) include a framework for determining and measuring the level of specific provisions and the GRCL and how this framework is applied on an individual facility or collective basis. This may include regard to the application of prescribed provisioning requirements under Attachment C;
 - (e) provide for the collection and maintenance of the level and type of data and other information required to enable the ADI to meet the objectives underpinning the adequacy of specific provisions and the GRCL. This includes having the required quality, type and volume of data necessary for use in credit risk models, other statistical techniques and tools utilised by the ADI in its credit risk management. The policies and procedures must also address the processes for ensuring the integrity of such data and information;
 - (f) provide for the validation of credit risk models and other statistical techniques used to determine levels of credit risk, estimated impairment of facilities, specific provisions and the GRCL. This includes the methodology (e.g. back tests and stress tests) used to validate models and statistical techniques utilised, as well as the frequency with which such validation will be conducted. Validation and relevant statistical analysis must be conducted on a timely basis and must provide for periodic independent review (e.g. by internal and external audit) with the results of such processes reported to the Board and senior management;
 - (g) cover the process for ensuring a consistent approach across the ADI, and through time, for the reporting of specific provisions and the GRCL. Changes or differences in approach must be capable of being justified and must be approved at the appropriate level; and
 - (h) outline the information to be provided on estimated impairment of facilities, specific provisions and GRCL, and credit quality more generally, to the Board and senior management. This must include frequency of reporting and processes to ensure the completeness and accuracy of relevant information flows. In addition, information must allow compliance with the policies and procedures approved by the Board, with respect to credit risk management to be monitored.

32. Specific provisions and the GRCL reported to APRA must:
- (a) reflect the economic substance of factors that affect the credit quality of facilities and not merely the legal form of facilities;
 - (b) be transparent and based on reasonable estimates and processes (e.g. models or other statistical techniques);
 - (c) be free of any material error or bias; and
 - (d) demonstrate prudence having regard to all significant factors which at the time might reasonably be considered could affect payments under facilities.¹⁵
33. In applying models and formulae for determining impaired facilities, specific provisions and the GRCL, an ADI must regularly review the appropriateness of the assumptions underpinning these models and formulae and update these as necessary.
34. Oversight of the recognition of impaired facilities, and the application of provisioning and reserving, will necessarily require the exercise of experienced credit judgement by senior management of an ADI and, where relevant, input by the Board. Policies and procedures must address the circumstances in which such judgements may be exercised. The exercise of judgement must be:
- (a) based on supportable assumptions, having regard to all relevant circumstances and supported by adequate documentation;
 - (b) conducted with prudence; and
 - (c) documented sufficiently to enable an understanding of why such judgements have been exercised.
35. The policies and procedures established by an ADI in relation to the management of credit risk, including recognition and measurement of impairment of facilities, specific provisioning and reporting of the GRCL, may vary according to the complexity, scope and scale of the business activities undertaken by the ADI. APRA will have regard to such features of an ADI's operations in assessing these policies and procedures.

Management of facilities

36. An ADI may manage facilities provided to entities on an individual (including a transaction basis) or portfolio basis. In accordance with Australian Accounting Standards, an ADI may assess facilities for impairment, and thus for

¹⁵ For example, in addition to consideration of historical loss experience and current economic conditions, other factors to be considered could include the effect of changes in an ADI's credit policies, client entity profiles, and projected changes in economic, legal and business conditions.

provisioning purposes, on an individual or portfolio (collective) basis, irrespective of whether the facilities are managed on an individual or portfolio basis.

37. An ADI must be able to satisfy APRA, if required, that its policies for determining whether a facility is managed on an individual or portfolio basis, and whether it is provisioned on an individual or portfolio basis, provide for prudent oversight of the credit risk associated with the level of exposures represented by an individual facility. This is particularly important where potential losses from an individual facility may be material having regard, for example, to the capital base, earnings capability, size or market profile of an ADI.

Collective provisions

38. The calculation of collective provisions may be based on an ADI's historical loss experience adjusted as appropriate for current circumstances, trends, conditions and other relevant factors that might affect payment of facilities on a portfolio basis over a period of time. Also, collective provisions may involve more complex techniques, such as the use of models and other statistical techniques. Such provisions may also have regard to the exercise of experienced credit judgements.

Estimated future credit losses over the life of a portfolio

39. Estimated future credit losses must reflect the credit risk inherent in all the individual facilities making up an ADI's business. The determination of estimated future credit losses must be forward-looking, reasonable and realistic, including having regard to consideration of all significant factors that affect the collectibility of the facilities making up the ADI's business as of the assessment date. Factors may include, but are not limited to, historical loss experience and recent trends in losses, but must also consider any factors that are reasonably likely to cause losses associated with the ADI's portfolio to differ over time from historical experience. These may include, but are not limited to:
 - (a) amendments to credit (e.g. lending) policies and procedures including, for example, changes in types of entities with which an ADI may undertake business;
 - (b) changes in the ADI's risk profile as a whole;
 - (c) developments in economic, business, market and regulatory conditions that affect an ADI's target markets, including, importantly, the impact of changes in economic and credit cycles;
 - (d) changes in the trend, volume and severity of impaired facilities and past due exposures which might be considered likely to extend over a reasonable period of time;
 - (e) scenario modeling; and

- (f) the existence, and effect, of any concentrations in the portfolio and changes in the level of such concentrations.
40. Historical loss analysis and assumptions used in any modelling or statistical approach to estimating future credit losses must reflect reasonable time periods for assessing such losses in an ADI's business, including at least one full credit cycle applicable to the type of credit exposures held by the ADI. Where data for such a period is not available, an ADI must be able to demonstrate to APRA, if required, what measures it took (if any) to address limitations in data coverage in assessing possible credit losses.

General Reserve for Credit Losses

41. In determining levels of the GRCL, an ADI must have a realistic and comprehensive view of all of its business activities (including both on- and off-balance sheet exposures) and must adequately consider uncertainty and all relevant risks inherent in those activities.
42. Policies and procedures covering the reporting of the GRCL must provide for systematic assessments and be well documented, with clear explanations of supporting analysis and rationale. Such policies and procedures must, amongst other features, address the role and responsibilities of the Board and senior management in determining and monitoring the adequacy of specific provisions and the GRCL.
43. When determining the level of the GRCL, an ADI must have regard to the following:
- (a) the GRCL must not act as a substitute for the establishment of adequate specific provisions or the recording of an appropriate write-off for bad debts. As soon as adequate information is available to identify losses or to estimate losses on individual facilities, a suitable specific provision must be reported or a write-off for bad debts must occur as appropriate; and
 - (b) the limitations of the estimates or projection of future credit losses. The greater the limitations and uncertainty of estimates, the higher the coverage of such estimates by a GRCL.
44. The GRCL can be determined by using one or several different methodologies which provide guidance as to the intrinsic risk which might be estimated to exist in an ADI's credit profile. These include:
- (a) applying a formula to a portfolio that takes into account factors such as past loss experience;
 - (b) migration analysis;
 - (c) the use of statistical applications; and

- (d) estimating losses having regard to an ADI's judgement of the impact of recent events and changes in economic conditions on credit activities.¹⁶
45. The application of these methodologies to the credit portfolio must be consistent with the nature and scale of an ADI's credit operations and management information systems.

¹⁶ For example, changes in legislation impacting on an ADI's ability to pursue problem debtors in a particular industry may cause a portfolio of loans to face a greater risk of loss through time.

Attachment C

Prescribed Provisioning

Principles

1. This Attachment details the prescribed provisioning methodology referred to in this Prudential Standard.
2. Where an ADI undertakes prescribed provisioning, the level of prescribed provisions must be reported to APRA notwithstanding the level of any provisions which an ADI may have actually raised, or the form in which such provisions have been reported, in its audited published financial reports (e.g. whether as collective provisions or provisions assessed on an individual basis)¹⁷. Where an ADI establishes such provisions in excess of those prescribed, the ADI must continue, for capital and APRA reporting purposes to include any excess provisions, as part of its specific provisions or GRCL as appropriate (refer to Attachment B).
3. Prescribed provisions do not apply where an ADI is not required to hold capital against the value of any assets sold, transferred or originated into a securitisation vehicle in accordance with APS 120. However, where securitised assets do not meet APRA's operational requirements for regulatory capital relief, these assets must be captured under the prescribed provisioning requirements contained in this Attachment. Prescribed provisioning does not apply to facilities that have been restructured and are not required to be treated as impaired.
4. The amount of prescribed provisions that an ADI is required to hold will, unless otherwise agreed with APRA, in writing, be in addition to any GRCL which it must hold.
5. A prescribed provision must be treated as a specific provision for capital and APRA reporting purposes and reported on an after-tax basis. Any deferred tax asset associated with the prescribed provision must be removed. Prescribed provisions must be deducted from an ADI's Common Equity Tier 1 Capital unless the amount of the prescribed provision has otherwise not been included in Common Equity Tier 1 Capital.
6. Where the Board or senior management of an ADI believe that the prescribed provisions calculated in accordance with this Prudential Standard do not

¹⁷ For example, should an ADI report collective provisions of \$10 million covering Category Two facilities but is required to recognise prescribed provisions of \$12 million covering such facilities, the ADI will be required to deduct \$2 million from its Common Equity Tier 1 Capital to capture the full effect of its prescribed provisioning requirements. The \$12 million in prescribed provisions (including the \$10 million captured in an ADI's collective provisions) must be excluded from its regulatory capital.

reasonably address assessed loss outcomes, they must report additional specific provisions. The level of specific provisions required will depend on the type of facility and term of payments past due or the period of irregularity in cash flows due on a facility.

7. Alternatively, where an ADI can satisfy APRA that the level of provisioning prescribed under this Attachment is higher than it might prudently require, the ADI may seek APRA's written agreement to report a lower level of such provisions as specific provisions. The difference between the level of provisions prescribed under this Attachment and that which it is agreed an ADI might prudently report may instead be included as part of the ADI's GRCL or, alternatively, may be returned to Common Equity Tier 1 Capital as agreed with APRA. An ADI will need, however, to fully satisfy APRA that its estimates of its provisioning needs are both prudent and comprehensive. Notwithstanding any reductions in amounts of prescribed provisions required to be reported, an ADI must continue to report a prudent level of a GRCL.
8. An ADI subject to prescribed provisioning arrangements must determine its specific provisions for capital and APRA reporting purposes in accordance with the four categories of *past due* facilities defined in this Attachment. The prescribed provisions calculated represent a minimum level of specific provisioning that an ADI must report, subject to paragraph 7 of this Attachment. Any existing individually assessed provisions calculated on facilities represented in a particular category may be included as part of the prescribed provisions for these purposes. In the event that an ADI has insufficient provisions assessed on an individual basis and collectively assessed provisions required to be recognised as specific provisions (refer to Attachment B), the ADI will need to reduce its Common Equity Tier 1 Capital by an amount necessary to ensure its provisions reported to APRA meet its required holdings of prescribed provisions.

Definitions

9. Where a facility maintained by an ADI utilising prescribed provisioning does not fall into the four categories of facilities outlined in this Attachment and the facility is an impaired asset (refer to Attachment A), the amount of provision to be held against this item must reflect the risk involved and must be agreed with APRA.
10. A facility is past due or irregular when a contracted payment (principal or interest) has not been met when due or it is otherwise outside contracted arrangements (e.g. an overdraft is over limit). Other definitions are:
 - (a) 'Term of payments' past due is the dollar value of contractual payments of principal and/or interest in arrears for a given period of time in the case of facilities with contracted repayment schedules. If the dollar value of 150 days' worth of contractual payments were past due, for example, then the amount of prescribed provision would be based on the provisioning percentages relevant to the time band '90 days and less than 182 days'; and

- (b) 'Period of irregularity' is the number of consecutive days for which contractual payments of principal and/or interest due on a revolving credit facility are outstanding and/or the number of days where a revolving credit facility is in excess of its authorised limit or a savings account is overdrawn.
11. Except where otherwise stated, security must, for the purpose of this Prudential Standard, be valued at fair value (refer to Attachment B).

Categories of past due facilities

Category One facilities

12. Category One facilities are well-secured (refer to Attachment A) and include:
- (a) a facility that is secured by a registered first mortgage against a residential property and is insured by an eligible lenders mortgage insurer (as defined in APS 112) for 100 per cent of the outstanding balance;
 - (b) a facility that is secured by a registered first mortgage against a residential property, where the ratio of the outstanding balance, less the amount of mortgage insurance, to the valuation of the security is no more than 80 per cent (where the exposure is 90 days or more worth of payments past due, and the valuation is not older than 12 months); and
 - (c) a facility that is secured by a registered second mortgage against a residential property where:
 - (i) the ratio of the outstanding balances of the facilities secured by both first and second mortgages to the valuation of the residential property does not exceed 80 per cent, and the first mortgage cannot be extended without it being subordinated to the second mortgage; or
 - (ii) where the ratio of the outstanding balances of the facilities secured by both first and second mortgages to the valuation of the residential property exceeds 80 per cent, and the first mortgage cannot be extended without it being subordinated to the second mortgage, and the outstanding balance is 100 per cent mortgage insured by an eligible lenders mortgage insurer (as defined in APS 112).
13. No prescribed provisions are mandated for Category One facilities. In the event that an ADI reports provisions covering Category One facilities, as part of its collective provisions, they must be dealt with in accordance with this Prudential Standard.

Category Two facilities

14. A Category Two facility is defined as a facility that is secured by a registered first mortgage against a residential property, where the ratio of the outstanding

balance, less the amount of mortgage insurance, to the valuation of the security is greater than 80 per cent but no more than 100 per cent (where the loan is 90 days or more worth of payments past due, and the valuation is not older than 12 months).

15. For Category Two facilities, the prescribed provision shall be a percentage of the balance outstanding, where the percentage depends upon the term of payments past due, as shown below.

Term of payments past due	Amount of Provision (%)
Up to 90 days	0
90 days and less than 182 days	5
182 days and less than 273 days	10
273 days and less than 365 days	15
365 days and over	20

16. Where the provision calculated under Category Two facilities is greater than the provision that would have been calculated under Category Three facilities, the latter must be taken as the prescribed provision.

Category Three facilities

17. This category applies to all facilities that do not fall into Categories One, Two, or Category Four. Personal and commercial loans (both secured and unsecured), and mortgage loans where the ratio of the outstanding balance, less the amount of mortgage insurance, to the valuation of the security is greater than 100 per cent, are included.
18. The minimum provision for these items will be a percentage of the balance outstanding, where the percentage depends upon the term of payments past due, as shown below.

Term of payments past due	Amount of Provision (%)
Up to 90 days	0
90 days and less than 182 days	40
182 days and less than 273 days	60
273 days and less than 365 days	80
365 days and over	100

19. Where a facility is secured by a mortgage over a residential property, the provision may be adjusted to reflect a part of the fair value of collateral held as security (refer to Attachment B). When this occurs, the minimum provision percentage in the table above must be applied to the difference between the outstanding balance (less any loan insurance) and 70 per cent of the security value (where the exposure is 90 days or more worth of payments past due, and the valuation is not older than 12 months). Where a facility is secured by other than residential property, an ADI may approach APRA to discuss an appropriate basis upon which to value security held.

20. Where a facility is otherwise secured by equivalent or better security arrangements than that described in paragraph 19 of this attachment, an ADI may, on application to APRA, seek to have the provision adjusted to reflect the whole or part of the fair value of collateral held. APRA may agree to an adjustment if it is satisfied that the provision, as adjusted, more appropriately covers the risk on the facilities. APRA will apply the following guidelines in considering the application:
 - (a) guarantees provided by Commonwealth or State Governments, or ADIs, may be deducted from the full value of the facility prior to applying the prescribed provisioning requirements;
 - (b) Crown leases involving property used for residential purposes may be adjusted in accordance with this Attachment;
 - (c) bank bills and Government Securities held as collateral, if subject to enforceable security in favour of the ADI, may be deducted from the value of the facility at their fair value (refer to Attachment B) prior to applying the prescribed provisioning requirements; and
 - (d) cash on deposit with the ADI may only be deducted (from the full value of the facility prior to applying the prescribed provisioning requirements) for the purposes of prescribed provisioning where the deposits are secured by appropriate contractual arrangements that satisfy the eligible collateral provisions contained in APS 112. A right of offset is not considered to provide appropriate security *per se*.

Category Four facilities

21. This category applies to overdrawn savings accounts and overdrawn limits on credit cards, overdrafts and line of credit advances. The minimum provision on these items shall be a percentage of the balance outstanding, where the percentage depends on the period of irregularity, as shown below. In calculating the minimum provision for each item, except for overdrawn savings accounts, the full amount of the credit drawn is to be included in the balance outstanding. For overdrawn savings accounts, the provision is only applied to the overdrawn amount.

Period of Irregularity	Amount of Provision (%)
Up to 14 days	0
14 days and less than 90 days	40
90 days and less than 182 days	75
182 days and over	100

Restructured items, assets acquired through security enforcement and other real estate owned

22. Provisioning, including prescribed provisioning, does not apply to formally restructured facilities, assets acquired through security enforcement and other real estate owned which meet the requirements for items to qualify as non-impaired (refer to Attachment A).

Attachment D

Credit Risk Grading Systems

Nature of Credit Risk Grading Systems

1. Credit risk grading systems (CRGS) offer a number of benefits that provide for a more systematic assessment of an ADI's asset quality and credit strategy. The benefits include:
 - (a) the provision of insights into the quality of an ADI's credit portfolio and its risk appetite at a point in time;
 - (b) facilitation of migration analysis that can highlight changes in the risk profile and trends in asset quality;
 - (c) acting as an early warning system for the detection of asset quality problems by highlighting credits with above normal risks. This often allows for special monitoring of such facilities, and enables the development of strategies to eliminate any weaknesses;
 - (d) as a basis for more sophisticated provisioning methodologies;
 - (e) providing a foundation for risk-based pricing mechanisms; and
 - (f) improving portfolio management, especially when combined with applications that can identify degrees of risks associated with lending on an industry, geographic or counterparty basis.
2. APRA does not favour the imposition of a standard CRGS for all ADIs. Rather, APRA will rely upon the CRGS adopted by each ADI. An ADI intending to implement a system or an ADI wishing to upgrade its credit functions, must address the following:
 - (a) coverage should extend to as much of an ADI's portfolio as possible, including off-balance sheet exposures. Risk grading facilities which are homogenous and have same risk characteristics on a portfolio basis is acceptable;
 - (b) for applicable exposures, the system must cover both performing and impaired assets to provide for the migration of an exposure from fully performing to loss status;
 - (c) for those systems grading customer quality independent of loan structuring and security considerations, exposures involving related parties should generally be classified on a group basis;

- (d) a regular independent review function to provide assurances about the reliability of the grading process must be established;
- (e) arrangements for the periodic validation of the grading model to ensure that it continues to deliver reliable information and adequately distinguishes between exposures of varying credit quality;
- (f) a sufficient number of risk grades to ensure that the system adequately captures gradation of risk; and
- (g) poorer quality facilities must include at least four categories along the lines indicated below:
 - (i) 'special mention', where clients are experiencing difficulties which, if they persist, could result in losses – such clients should be subject to special monitoring, including more frequent review and management scrutiny;
 - (ii) 'substandard', where definable weaknesses are evident which could jeopardise repayment, particularly of interest – the ADI is relying heavily on available security;
 - (iii) 'doubtful', where the situation has deteriorated to such a degree that collection of the facility amount in full is improbable and the ADI expects to sustain a loss; and
 - (iv) 'loss', where facilities are considered uncollectible within a reasonable time frame – this should be viewed as a transitional category for facilities which have been identified as requiring write-off during the current reporting period.

Link between the credit risk grading and impaired asset reporting

3. Greater consistency, and some operational efficiencies, may be achieved where an ADI establishes links between its systems and APRA guidelines for measurement and reporting of impaired assets. By way of example, facilities that are on a non-accrual basis would normally be classified as 'doubtful' in a credit risk grading system while facilities that have been restructured would normally be classified as 'substandard'. For ease of classification, an ADI may choose to establish automatic links between risk grades and impaired asset reporting. It is recognised, however, that there will not always be a direct correlation between the two, and some flexibility is necessary when establishing these links. An ADI should inform APRA where this occurs. Where relevant, APRA may discuss such inconsistencies with an ADI.

Internal reporting and reporting to APRA

4. Internal management and Board reporting must seek to take the maximum advantage of an ADI's CRGS. Appropriate reports should be generated regularly.

5. An ADI, having established a CRGS, must include APRA among the recipients of information on its graded portfolio. The format of the report may be consistent with that used for management information purposes. ADIs must also provide details on the amount of provisions held against the various categories of poorer quality facilities. Information on an ADI's graded portfolio must be provided to APRA on a quarterly basis, in conjunction with the ADI's quarterly reporting on asset quality.