Wolters Kluwer

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[redacted]

May 30, 2019

To,

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

By email: ADIpolicy@apra.gov.au

Dear Sir/Madam,

Re: Discussion Paper on APS 220 Credit Risk Management

Wolters Kluwer would like to thank APRA for providing the opportunity to submit comments on the "Discussion Paper on APS 220 Credit Risk Management".

Wolters Kluwer is the world's leading provider of integrated Finance, Risk and Regulatory Reporting solutions for financial institutions. Wolters Kluwer offers software products around credit risk computation such as IFRS 9 computation (Classification & Measurement, ECL and Hedge accounting) and Basel III RWA computation, and has worldwide client coverage in these products. Wolters Kluwer has been named IFRS 9 category leader by Chartis Research. At the core of all our software solutions is the financial data architecture (FDA), a data model has been endorsed and implemented by major banks and financial institutions operating across the full range of the financial services industry. Any financial product and customer transaction can be modelled within the data model with no limit on the granularity supported. The data model caters for the financial product data, market data and static data. We also have a workflow process.

In Australia, Wolters Kluwer has wide client coverage in its regulatory reporting software product and supports a wide range of ADIs/RFCs with end-to-end automation of their APRA reporting process. Amongst our clients are some of the smallest ADIs/RFCs and several of the country's largest domestic financial domestic financial institutions. As the largest provider of regulatory reporting compliance solutions in the Australian financial services industry, Wolters Kluwer has quite a unique vantage point across regulated institutions.

From our experience of helping our clients with compliance to IFRS 9 and Basel III related computation requirements, this letter contains Wolters Kluwer's comments for APRA's consideration.

Comments on the proposal

For adequate Credit risk management and to enable the board to be well informed, the need for availability and retrieval of data, and the corresponding analytics cannot be emphasized enough. This will require an all encompassing data model with ability to drill down to the most granular level acting as a central source and facilitating the data storage and retrieval as well as being compatible with the various data visualization tools. Similarly a robust workflow process helps to map out the entire credit lifecycle with necessary monitoring flags (e.g. upon limit breaches or override credit deterioration), allows management interventions and facilitates necessary adjustments/actions.

Following is our observation regarding some of the sound practices in credit risk management and attention areas.

Banks following best practice define lending strategies by identifying target market. For example, target market in corporate lending is set by factors such as market size, industry, geography. Based on their analysis of credit risks in a target market, banks with sound credit policies set risk acceptance criteria and perform credit underwriting based on the criteria. Also, they flag and monitor deviations from the criteria.

For operational efficiency reasons, there may be a need for banks to grant business units with some credit exceptions approving powers. However, as business units have sales mandates, they may face conflicts of interest when exercising their approving authority. Appropriate limits and controls should therefore be established to mitigate such risks. In such instances of credit exceptions, the credit decisions might be mainly based on the individual credit approvers' risk tolerance levels and may result in inconsistent application of underwriting standards.

Banks should also be cognizant of potential higher risk credit practices such as the substitution of trade finance facilities with general purpose working capital facilities, inappropriate granting of bullet loans, and loans priced below hurdle rates. Corresponding to the trade finance facilities which are shorter-term in nature, are self-liquidating and have higher documentary requirements, the working capital facilities are higher risk and therefore should be underwritten according to the standards of a working capital loan. For example, underwriting should include thorough assessment of the borrower's financials and should be priced according to its risk.

Loans priced below hurdle rates should be actively managed to improve returns or should be exited. For example, if a loan has been underpriced in expectation of fee income then the profitability analysis of the loan should also include realization of the fee income apart from the interest income.

Banks with sound risk management practice grant bullet loans only when they are appropriate for the purpose of the loan, and the repayment structure is aligned with the borrower's cash flow and source of repayment. Such banks also implement measures to ensure that their credit risks are adequately mitigated. For example, it is not uncommon to see bullet loans refinancing or rolling over at maturity. It is therefore critical that bullet loans are priced taking into account the borrower's refinancing/rollover risk and expected tenure.

Credit policies accounting for debt-to-income and debt-service ratio thresholds and testing the accuracy of the ratios as well as stressing cash flows to check for potential breaches to the thresholds are among the sound practices.

Besides managing loans individually, banks undertake credit portfolio reviews and stress testing exercises. The rate of policy overrides/waivers/exceptions should be monitored at the portfolio level and, where necessary, individual accounts contributing to the override/waiver/exception should be dived into as well and tracked for performance. These reviews/actions should be either undertaken or validated by the risk department and done frequently such as quarterly with approval for any deferment of scheduled reviews.

ADI's should develop watchlist criteria based on factors such as Industry, Ownership, Balance Sheet, Cash Flow, Debt Service Capacity, Ageing etc. Banks should ensure that there are systems or processes in place to promptly identify negative news pertaining to borrowers and assess the implications on the quality of the loans. With the implementation of the IFRS9/AASB9 accounting standards, watchlist process has become an important means to identify accounts as significantly increased in credit risk.

Given the impact on exposure and thus on the impairment/capital, stress testing and scenario analysis around full utilization of the unutilized limit should also be undertaken. The stress testing exercises can be either mandated by regulators or can be initiated by the bank. Banks have long engaged in stress test exercises to gain portfolio insights. Banks are now shifting towards also taking portfolio actions such as formulating capital and performance management strategies.

APRA has proposed to require collateral valuations to be appraised independently from an ADI's credit origination, assessment and approval processes. This would require the frequency of the collateral valuation to be high, with deviations documented and mitigating measures introduced. For example, 70% of the collaterals could be re-valuated every quarter on a rotating basis. APRA has also proposed that valuations take into account prevailing market conditions such as time taken for the liquidation or realization of collateral. Sound risk practices include having policies on collateral management with quantitative and qualitative guidelines to manage liquidation risk of physical collaterals, liquidity risk of financial collaterals, and foreign exchange risk when loans and collaterals were denominated in different currencies

Since its last substantial update in 2006, this discussion paper is aimed at modernization of the credit risk management standards, also in light of the AASB 9 accounting standards. We believe that given their current risk management practices, the big banks may already be following several of the standards. Therefore, we believe that the aim of this new standard is to require that <u>all</u> ADIs are at or above a certain level of threshold of credit underwriting, monitoring and management standards and to provide a level playing field for all ADIs. We also appreciate that ADIs need to modify their credit risk standards resulting from the implementation of the new accounting standards under AASB 9. However, the success of the adoption will depend on the specific details of the standards laid out in any given bank (for example on the lines that described in the previous paragraph) and the governance around the monitoring of the standards.

Should you have any queries regarding any of the above or about Wolters Kluwer in general, please do not hesitate to contact us at [redacted].