DISCUSSION PAPER

APS 220 Credit Risk Management

March 2019

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Executive summary

Credit risk – the risk of borrower default – is usually the single largest risk facing an authorised deposit-taking institution (ADI). The presence of a well-functioning credit risk management system is, therefore, fundamental to the safety and soundness of an ADI.

The existing *Prudential Standard APS 220 Credit Quality* (APS 220) requires an 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 exposures.

Since APS 220 was last substantially updated in 2006, APRA has increased its expectations of credit standards and the ongoing monitoring and management of an ADI's credit portfolios.

Credit risk relating to residential mortgage lending has been a key area of supervisory focus for APRA in recent years. Specific areas of prudential concern have included credit standards and particular types of higher-risk lending, such as interest-only lending. In regard to commercial property lending, competitive pressures have also negatively impacted credit standards. APS 220 needs to be updated to reflect the outcomes of APRA's reviews in these areas.

In addition, the new accounting standard *AASB 9 Financial Instruments* (AASB 9) provides for an expected loss approach to provisioning for credit losses. While APRA's existing treatment of provisioning is also forward-looking, the existing APS 220 reflects concepts and terminology commensurate with the prior accounting incurred loss approach.

In light of these issues, APRA is reviewing and modernising APS 220. Accompanying this discussion paper, APRA is releasing a draft revised prudential standard for consultation.

APRA is proposing to rename APS 220 as *Prudential Standard APS 220 Credit Risk Management* to better describe the purpose of the revised standard.

The revised standard is broader than the existing APS 220, covering credit standards and the on-going monitoring and management of an ADI's credit portfolios in more detail. The proposed requirements also include enhanced Board oversight of credit risk and the need for an ADI to maintain prudent credit risk policies, processes, practices and controls over the full credit life-cycle.

APRA is also reviewing APS 220 to take into account recent guidance issued by the Basel Committee on Banking Supervision (Basel Committee), notably, on asset classification, and sound credit risk practices associated with the implementation and ongoing application of an expected loss accounting approach.

The final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry also identified a range of areas where the regulation and supervision of financial institutions should be strengthened. The revised APS 220 includes the recommendations relevant to the revision of APS 220 regarding the valuation of collateral taken by ADIs.

APRA intends to implement the proposed reforms to APS 220 from 1 July 2020.

Glossary

AASB 9	Accounting Standard AASB 9 *Financial Instruments*
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 111	*Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*
APS 113	*Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*
Basel Committee	Basel Committee on Banking Supervision
CPS 220	*Prudential Standard CPS 220 Risk Management*
General reserve for credit losses (GRCL)	Under the existing APS 220, a reserve held against future, presently unidentified losses, whether for individual or grouped exposures.
Past-due	Where any amount due under a contract (interest, principal, fee or other amount) has not been paid in full at the date when it was due. An exposure is considered past-due from the first calendar day of missed payment, even when the amount of the exposure or the past-due amount, as applicable, is not material.
Significantly deteriorated	An exposure where provisions are measured on a life-time expected loss basis under Australian Accounting Standards but is not non-performing.
Tier 2 Capital	Other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital but nonetheless contribute to the overall strength of an ADI and its capacity to absorb losses.

Chapter 1: Introduction

1.1 Background

Credit risk is usually the single largest risk facing ADIs. It is most simply described as the potential that a borrower will fail to meet its obligations in accordance with agreed terms.[1] ADIs need to manage the credit risk of individual borrowers as well as for the portfolio as a whole. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term viability of any ADI.

For most ADIs, loans, particularly residential mortgage loans, are the largest and most obvious source of credit risk. However, other sources of credit risk exist throughout the activities of an ADI, including in the banking book and in the trading book. ADIs may face credit risk in various financial instruments other than loans, including acceptances, inter-bank transactions, trade financing, foreign exchange transactions, derivatives, bonds, equities, and in the extension of commitments and guarantees, and the settlement of transactions.

APRA's existing prudential standard on credit risk management, APS 220, requires an 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 exposures. Although the principles contained in APS 220 are most clearly applicable to the business of lending, they should be applied to all activities where credit risk is present.

APRA has observed deficiencies in credit risk management. APRA's supervisory review of residential mortgage exposures revealed, for example, concerns regarding many ADIs' assessments of potential borrowers' ability to service a loan. As part of its work on residential mortgage lending, APRA also highlighted the importance of Board oversight of evolving risks, including the need for increased Board understanding and monitoring of risks within the credit portfolio.[2]

APRA's recent review of commercial property lending practices also noted an erosion of credit standards due to competitive pressures. The ability of the Board and senior management of an ADI to fully understand and challenge the risk profile of lending have often been hampered by inadequate data, poor monitoring and incomplete portfolio controls.[3]

[1] A reference to a borrower in this Discussion Paper includes a reference to a counterparty.

[2] APRA Letter: *Reinforcing sound residential mortgage lending practices,* 9 December 2014; APRA Letter: *Further measures to reinforce sound residential mortgage lending practices*, 31 March 2017; and APRA Letter: *Embedding sound residential mortgage lending practices*, 26 April 2018. APRA letters are available at: https://www.apra.gov.au/letters-notes-advice-adis.

[3] APRA Letter: *Commercial property lending - thematic review considerations,* 7 March 2017.

The outcomes of APRA's recent reviews of credit standards are not reflected in APS 220. APRA's last significant update of the prudential standard was in 2006. Since then, credit risk management practices have evolved to include more sophisticated analytical techniques and information systems.

Other significant developments relating to credit risk have also occurred since the last significant update of APS 220. In particular:

- the new accounting standard has adopted a forward looking approach to provisioning rather than the incurred loss approach under the previous accounting standard;[4] and
- the Basel Committee has released supervisory guidance on sound credit risk practices associated with the new accounting standard and asset classification. These guidance promote high-quality and robust assessments and measurements of expected loss under the new accounting framework and harmonisation in the measurement and application of credit quality, thereby promoting consistency in supervisory reporting and international comparability.[5]

In light of these issues, APRA is reviewing APS 220 to incorporate outcomes from its recent supervisory focus on credit standards and reflect contemporary credit risk management practices over the full credit life cycle. APRA is also reviewing the standard to better align it with the accounting standard changes on provisioning, for other guidance on credit related matters of the Basel Committee and on the Royal Commission's recommendations in its final report made in respect of the valuation of land.[6]

APRA is also proposing to re-name APS 220 as *Prudential Standard APS 220 Credit Risk Management* to better describe the revised standard.

1.2 Proposed revisions to APS 220

The main revisions to APS 220 include the following:

[4] AASB 9 *Financial Instruments* (AASB 9) applies for reporting periods beginning on or after 1 January 2018 and replaced AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139).

[5] The Basel Committee guidance on credit risk and accounting for expected credit losses, December 2015, available at: https://www.bis.org/bcbs/publ/d350.htm and the Basel Committee guidance on the prudential treatment of problem assets - definitions of non-performing exposures and forbearance, April 2017, available at: https://www.bis.org/bcbs/publ/d403.htm.

[6] Recommendation 1.12 - Valuations of land, The Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, available at: https://treasury.gov.au/publication/p2019-fsrc-final-report/.

Table 1: Proposed revisions to APS 220

Credit risk management	• An ADI must maintain an appropriate credit risk appetite statement and credit risk management strategy. • An ADI's credit risk management strategy must reflect the ADI's credit risk appetite and credit risk profile. • An ADI must maintain prudent policies and processes to identify, measure, monitor, report and control or mitigate credit risk over the full credit life cycle.
The role of the Board and senior management	• The Board of an ADI must review and approve on at least an annual basis, the credit risk appetite statement and the credit risk management strategy of the ADI. • The Board must regularly challenge, seek assurance and evidence from senior management that the ADI's credit risk policies, processes and practices are consistent with the credit risk management strategy (and, in turn, the credit risk appetite) of the ADI. • The Board must obtain sufficient information to confirm whether or not the credit risk profile of the ADI is consistent with the credit risk management strategy, and require senior management to take appropriate action if it is not. • Senior management must have responsibility for implementing the credit risk management strategy and appropriate policies and processes for identifying, measuring, monitoring, reporting and controlling or mitigating credit risk.
Credit risk policies and processes	• An ADI must set prudent limits on exposures to higher risk borrowers, higher risk credit products and activities and particular geographical locations (where appropriate).
Credit origination	• An ADI must recognise and address the risks arising from different origination channels in its credit risk management framework. • Where there are material changes to origination channels, an ADI must assess the impact of these changes on its credit risk profile and appropriately address the risks of such changes. • In circumstances where a third party (such as a broker or introducer) are involved in credit origination, but have no ability to approve credit risk, an ADI must have a sound oversight process of the third party.

Credit assessment and approval	• An ADI's credit assessment must include consideration of: the purpose and structure of the exposure and sources of repayment, including effective verification of income or cash flows; the current risk profile of the borrower, including all commitments and total indebtedness; the borrower's repayment history and capacity, assessed under various scenarios; and covenants designed to limit the ADI's exposure to changes in the future risk profile of the borrower. • For exposures to individuals (i.e. natural persons), the ADI must also consider the borrower's expenses, including the collection of realistic estimates of the borrower's expenses, which must be used where these are greater than expense benchmarks. • For exposures other than to individuals, an ADI must also consider: the borrower's business expertise, economic or industry sector and its position within that sector; the borrower's historical financial and future cash flows; and equity capital. • An ADI must establish appropriate limits on loan-to-valuation ratios (LVRs). • Where an ADI uses a third party (such as a broker) to undertake credit assessment and approval, an ADI must implement appropriate oversight processes of the third party. • Where an ADI has direct exposure to credit risk through a third party such as an on-line lending platform and the third party undertakes the credit assessment and approval of the underlying exposures under its own credit risk policies and processes, the ADI must perform due diligence on these exposures.
Ongoing monitoring and management of an ADI's credit portfolio	• An ADI must have an appropriate system for the ongoing administration of its credit portfolio. • An ADI must have an appropriate system for monitoring the condition of individual exposures, including determining the adequacy of provisions. • An ADI must have in place an appropriate system for monitoring the overall composition and quality of the credit portfolio.
Stress testing	• An ADI must undertake regular portfolio level and risk specific stress testing of its credit exposures.
Collateral valuations	• An ADI must ensure valuations are appraised independently from its credit origination, credit assessment and approval processes. • The valuation of collateral must take into account prevailing market conditions such as time taken for the liquidation or realisation of collateral. • In the case of agricultural land taken as security, an ADI must ensure the valuation takes into account the likelihood of external

	events, such as drought and flood, which may impact the valuation of the land.
Asset classification	• For prudential reporting purposes, an ADI must classify its exposures as 'performing', 'significantly deteriorated' or 'non-performing'. • For prudential reporting purposes, exposures that are 90 calendar days or more past-due, even if well-secured, must be classified as non-performing exposures; and restructured or 'hardship' exposures must meet modified terms over a 12 month period before returning to performing status.
Provisioning	• Removal of the general reserve for credit losses requirement from the revised standard.
Supervisory discretion to impose limits and other measures	• Discretion for APRA to undertake appropriate steps to address risks where it considers an ADI is taking excessive credit risk relative to its financial or operational capacity to absorb that risk. • Discretion for APRA to set limits on particular types of lending, to be complied with by all ADIs or a specified class of ADIs. • Discretion for APRA to undertake appropriate steps where APRA considers an ADI's policies, processes and practices across its credit risk activities do not meet the requirements of the revised standard, or an ADI's credit risk management is otherwise deficient. • Discretion for APRA to require an independent review of an ADI's credit risk management, including provisioning practices, for APRA to be able to set the terms of the review and at the ADI's expense.

1.3 Balancing APRA's objectives

APRA's mandate includes balancing the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, and, in balancing these objectives, promote financial system stability in Australia. APRA considers that, on balance, the proposals in this discussion paper will enhance prudential outcomes, improve financial safety and promote financial system stability.

Table 2: Primary objectives and other considerations

PRIMARY OBJECTIVES	
Financial safety	**Financial system stability**
Improved: The revised standard promotes prudent behaviour by ADIs, with the key aim of protecting the interests of their depositors.	Improved: The revised standard is likely to enhance credit risk management. In turn, this is likely to improve the resilience of ADIs.

OTHER CONSIDERATIONS	
Efficiency	Improved: The proposals are expected to improve efficiency as APRA is aligning the prudential requirements with the new accounting standard. The revised standard does not impose any additional material burden on ADIs.
Competition	No change: The proposals are expected to have a minimal impact on competition as APRA's expectations for the credit risk management approach used by individual ADIs is commensurate with the scope and sophistication of the ADI's activities. Changes to provisioning and reporting are also expected to have a minimal impact on competition as APRA is aligning the prudential requirements with the new accounting standard.
Contestability	No change: The revised standard has no impact on the ability of new entrants to enter the banking industry.
Competitive Neutrality	No change: The revised standard does not create advantage for public sector entities relative to other market participants.[7]

1.4 Timetable

APRA intends to implement the proposed reforms from 1 July 2020. An accompanying prudential practice guide (PPG) and revised reporting standards will be released, for

[7] APRA has previously interpreted the objective of competitive neutrality as ensuring consistency in the treatment of classes or types of institutions. To ensure alignment with Parliament's original intention, APRA now follows the more common usage of this term (for example, as found in the Commonwealth Competitive Neutrality Policy Statement). Ensuring consistency in regulatory treatment now falls within the competition objective.

consultation later in 2019. APRA expects that the final prudential standard, PPG and reporting standards, will be released by the end of 2019.

Chapter 2: Credit risk management framework

2.1 Credit risk management

APRA considers it appropriate for an ADI's credit risk management framework to cover credit standards, and the ongoing monitoring and management of an ADI's credit portfolio. APRA is proposing to broaden the existing APS 220 to capture the full credit life cycle (for example, this cycle starts with the first contact with a potential borrower and continues through to their final payment).

The revised standard will require an ADI to maintain: an appropriate credit risk appetite statement and credit risk management strategy that reflects its credit risk appetite and credit risk profile; prudent policies and processes to identify, measure, monitor, report and control or mitigate credit risk over the full credit life cycle; sound credit assessment and approval criteria; an appropriate system for the ongoing administration of its credit portfolio; and appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate provisions in accordance with accounting standards.

2.1.1 The role of the Board and senior management

The Board has a critical role in providing high-level advice and overseeing senior management with respect to matters relating to credit origination, credit assessment and approval, and the overall credit portfolio.

The revised standard complements CPS 220 with more detail on best practice credit risk management expectations, including enhanced Board oversight of credit risk. The Board must review and approve, on at least an annual basis, the credit risk appetite and the credit risk management strategy of the ADI.

The Board must regularly challenge, seek assurance and evidence from senior management that credit risk policies, processes and practices are consistent with the credit risk management strategy (and, in turn, the credit risk appetite of the ADI). The revised standard requires the Board to obtain sufficient information to confirm that the credit risk profile of the ADI is consistent with the credit risk management strategy and require senior management to take appropriate action if it is not.

The revised standard also provides clarity regarding the respective roles of the Board and senior management with the latter responsible for implementing the credit risk management strategy approved by the Board and appropriate credit risk policies and processes.

2.1.2 Internal risk appetite limits

APRA considers it prudent for an ADI to have appropriate internal risk appetite limits to ensure strong growth of higher risk lending does not inappropriately contribute to rising risks.

APRA is proposing that ADIs include in their credit risk polices prudent internal risk appetite limits to higher risk borrowers, higher risk credit products and activities, and particular geographical locations (where appropriate).

In many instances, due to an ADI's geographical location or lack of access to economically diverse borrowers, avoiding or reducing concentrations may be difficult. For these reasons, APRA is not proposing to include the specific quantum of limits in the revised standard as APRA expects the credit risk management approach used by individual ADIs is commensurate with each ADI's particular circumstances.

2.2 Credit origination, assessment and approval process

2.2.1 Credit origination

Sound origination practices are considered necessary whether exposures are originated directly by an ADI or are sourced from other origination channels. ADIs typically use various direct and indirect origination channels to source credit risk.

APRA is proposing to include in the revised standard the requirement for an ADI to recognise and address the risks arising from different origination channels in its credit risk management framework.

An ADI would typically exercise a higher level of diligence when the credit approval decision is made distant from the location of the borrower or the underlying collateral. In APRA's experience, ADIs that extend credit away from their core geographical market tend to be more reliant on third-party originators. If not closely monitored, this reliance can potentially lead to additional risk and give rise to higher levels of exposure that may be outside an ADI's credit risk appetite.

Where there are material changes to origination channels, the revised standard also requires an ADI's credit risk management framework to include assessment of the impact of changes to an ADI's credit risk profile and to address the relevant risks.

In circumstances where a third party (such as a broker or introducer) is involved in credit origination, but has no ability to approve credit risk, APRA is proposing that an ADI has a sound oversight process of the third party. In particular, an ADI must have prudent policies and processes to verify the accuracy and completeness of any borrower information provided by the third party.

2.2.2 Credit assessment and approval

Sound credit standards are critical in driving credit quality. APRA is proposing to include specific requirements for credit standards in the revised standard. These requirements are drawn from APRA's previous pronouncements on credit risk, particularly its recent supervisory measures to reinforce sound residential mortgage lending practices.

Not all aspects of the proposed credit standards requirements related to the business of lending would be relevant to specific credit products and activities (for example, derivative transactions, margin lending and reverse mortgages). An ADI would need to consider the nature, type and size of the exposure in assessing the credit risk of a borrower.

The main credit standards requirements focus on: capacity to repay, including effective verification of income or cash flows; consideration of a borrower's current risk profile, including all commitments and total indebtedness; a borrower's repayment history and capacity, assessed under various scenarios (for example, the application of prudent buffers); and covenants designed to limit the ADI's exposure to changes in the future risk profile of the borrower.

For exposures to individuals (i.e. natural persons), the revised standard also reiterates the need for collection of realistic estimates of borrower expenses rather than reliance on benchmark estimates, consistent with responsible lending obligations.

For exposures other than to individuals, the revised standard also requires an ADI to consider: the borrower's business expertise, economic or industry sector and its position within that sector; and the borrower's historical financial and future cash flows, and equity capital.

APRA is also proposing to include in the revised standard a requirement for an ADI to consider appropriate policy limits on high LVR lending. APRA is not proposing to include the specific quantum of policy limits, as well as floors, buffers and adjustments, given the different types of credit risk activities undertaken by an ADI. However, APRA expects an ADI's credit standards in regard to residential mortgage lending continue to have regard to the floors, buffers, adjustments and other guidance, as detailed in *Prudential Practice Guide APG 223 – Residential Mortgage Lending* (APG 223).

2.2.3 Third party credit assessment and approval

Sound oversight of a third party (such as a broker) is important in managing credit risk, even where an ADI uses the third party to undertake credit assessment and approval under the ADI's credit assessment and approval criteria. In this case, APRA is proposing that an ADI monitor and test the integrity of the third-party assessment and approval on a regular basis, either directly or through operationally independent personnel, to ensure it aligns with the ADI's credit assessment and approval criteria.

In other circumstances, an ADI may have direct exposure to credit risk through a third party, such as an on-line lending platform where requests from borrowers for loans are made and then matched against offers from the ADI to fund (partially or fully) a loan or loans, and the platform operator or other third party undertakes the credit assessment and approval of the underlying borrowers under its own credit risk policies and processes. This type of lending is often referred to as peer-to-peer (P2P) or marketplace lending, and the ADI typically has no ability to influence the credit risk policies and processes of the third party under these arrangements. The third party does not lend its own money, so all the credit risk is borne by the ADI. APRA's review of these exposures has revealed a lack of transparency of some of the structures and weaknesses in ADIs' risk management of the exposures, including a lack of strategic rationale for participation in this type of lending.

For these exposures, it is important that ADIs have a clear understanding of the associated risks and, as such, the revised prudential standard proposes that ADIs must undertake due diligence to gain a comprehensive understanding of the risk characteristics of the prospective and actual exposures. This would also include: timely access to, and review of, performance information on the exposures; and a comprehensive understanding of the structural features of the transactions. This is particularly important in more complex credit activities, such as those involving on-line lending platforms, because the risk involved may be less obvious and require more analysis than traditional credit risk activities. As part of the review of the ADI capital framework, APRA is also reviewing the appropriate capital treatment of these exposures, given the risks associated with P2P or marketplace lending.

2.3 Ongoing monitoring and management of an ADI's credit portfolios

2.3.1 Credit administration, measurement and monitoring

APRA's proposals in the area of credit administration, measurement and monitoring reiterate best practice credit risk management expectations. The revised standard reiterates the importance of comprehensive processes and information systems to monitor the condition and quality of individual exposures.

The identification of what may potentially go wrong in individual exposures and the various credit portfolios of an ADI and the factoring of this information into the analyses of the adequacy of capital and provisions is an important element of sound credit risk management. The revised standard specifically requires an ADI to undertake regular stress testing of its credit portfolios. Such testing is to involve the identification of possible events or future changes in economic conditions, such as economic or industry downturns, market-risk events and liquidity conditions that may have unfavourable effects on the ADI's credit exposures and assessment of its ability to withstand changes.

2.3.2 Controls over credit risk

APRA's proposals in the area of credit risk controls also reiterate best practice credit risk management expectations.

The revised standard requires an ADI to ensure that the credit origination, credit assessment and approval function is properly managed and that credit exposures are within levels consistent with the ADI's limits. APRA considers it prudent that an ADI's limit system prompts senior management into controlling credit exposures, initiating discussion about risks, and to monitor actual risk taking against the credit risk management strategy.

The revised standard also requires an ADI to establish a system of independent, regular reviews of its credit risk management processes and practices, and for the results of such reviews to be communicated directly to the Board and senior management. Such reviews must also be used to identify areas of weakness in the credit risk management process, credit risk policies and processes as well as any overrides/waivers/exceptions to policies, processes and limits.

APRA considers it appropriate that a deterioration in credit quality be recognised at an early stage when there may be more options available for improving the exposure. Therefore, an ADI must have a disciplined and vigorous remedial management process. The revised standard requires an ADI to have an appropriate system in place for early remedial action on problem exposures, managing deteriorating exposures and similar workout situations (for example, restructured exposures), with the segregation of the workout function from the area that originated the exposure.

APRA considers it important that an ADI have prudent policies and processes that assist the ADI to recover as much of an exposure as is reasonably achievable within the requirements established by law and have regard to community expectation as to how troubled borrowers would be treated. The revised standard requires an ADI to give due consideration to reputational risks in such circumstances.

2.4 Collateral valuation

The existing standard requires an ADI to utilise the valuations of suitably qualified internal and external appraisers in determining the fair value of security. Policies and processes covering the fair value of security must address the circumstances in which such valuations would be sought.

In line with the recommendations of the Royal Commission in its final report, APRA is proposing to revise the existing standard to require valuations: to be appraised independently from an ADI's credit origination, credit assessment and approval processes; to take into account prevailing market conditions such as time taken for the liquidation or realisation of collateral; and, in the case of agricultural land taken as security, to take into account the likelihood of external events, such as drought and flood, which may impact the valuation of the land.[8]

APRA is also proposing to update the standard to include recognition of the use of alternative valuation methods such as desk-top assessments, kerb-side assessments and automated valuation methods. Where an ADI relies on alternative valuation methods, it must have appropriate policies and processes which address when such valuations would be provided and the monitoring, validation and reporting of valuation data.

Further, APRA is also proposing some additional requirements in regard to a use of valuer panels, including the requirement for a panel to be reviewed at least annually by the ADI.

The existing standard requires an ADI to ensure that relevant legal requirements are met to maintain the ADI's security position and to provide for its enforcement. APRA is proposing to include additional requirements so that property serving as collateral is appropriately insured at the time of origination.

[8] Refer to Footnote 6.

Chapter 3: Asset classification

3.1 Performing, significantly deteriorated and non-performing

Asset classification is important to ADIs and APRA as it is used to assess the riskiness of an ADI's credit exposures and the quality of its loan portfolio, including benchmarking against other lenders and trends over time.

Differences in the definitions of terms used in the accounting and regulatory frameworks, such as the concept of impairment and the definition of default, present some challenges for ADIs in identifying and monitoring asset quality.

To provide a more consistent basis for the classification of exposures, and to provide consistency with international definitions, APRA is proposing to require ADIs to classify exposures as 'performing', 'significantly deteriorated' and 'non-performing' for prudential reporting purposes.[9] Such classification complements each of the credit risk stages under AASB 9, and importantly, does not change the accounting concept of impairment nor the regulatory definition of default. This is likely to result in a higher level of reported problem loans relative to APRA's current definition of impaired loans, but will not necessarily lead to an increase in provisions.

This proposal enhances international comparability of ADI reporting of non-performing exposures (see definition below) and provides clarity in mapping provisions to their regulatory treatment (see section below).

Table 3: Asset classification

Proposed APS 220 category	AASB 9 credit risk stage	AASB 9 expected loss provisions	Description of credit quality
Performing	Stage 1	12 month expected loss	Credit risk has not increased significantly since initial recognition.
Significantly deteriorated	Stage 2	Life-time expected loss	Credit risk has increased significantly since initial recognition.
Non-performing	Stage 3	Life-time expected loss	The financial asset is credit-impaired under AASB 9. This is effectively the point at which there has been an incurred loss event.

[9] This particular classification does not apply to a derivative transaction subject to a counterparty credit risk charge under *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180).

3.2 Non-performing exposures

APRA is proposing to define non-performing exposures as those that meet the definition of default under *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113). This means exposures that are 90 calendar days or more past-due, even if they are otherwise well-secured, will be captured as non-performing for prudential reporting purposes. This is slightly different to the existing APS 220, where the term 'impaired' rather than 'non-performing' is used and well-secured exposures are excluded from being classified as impaired.

APRA considers it appropriate that well-secured exposures that are 90 calendar days past-due are captured as non-performing, as security does not influence the past-due status of an exposure, including the counting of past-due days. This approach is also consistent with the principle that an ADI should not unduly rely on security in assessing capacity to repay.

The proposed definition of non-performing exposures is designed to provide consistency in ADIs' practices in asset categorisation, provide a better understanding of asset quality and improve the comparability of credit risk information reported.

3.3 Restructured exposures

A restructured or 'hardship' exposure occurs when a borrower is experiencing temporary financial difficulty in meeting its financial commitments and the ADI grants a concession that it would not otherwise consider.

APRA is proposing an ADI may return a restructured exposure to performing status when all payments under the revised contractual terms have been made in a timely manner over a continuous repayment period of not less than 12 months, compared to the shorter period of 6 months (or three payment cycles, whichever is longer) under the existing APS 220.

APRA considers a longer timeframe than 6 months may provide an ADI with a better indication of a borrower's likeliness to repay and more clarity around the actual level of credit risk in an ADI's balance sheet.

APRA is also proposing that restructured exposures may be included within the 'significantly deteriorated' or 'non-performing' category. The appropriate categorisation will depend on the status of the exposure at the time when concession is granted and the borrower's payment history after the extension of the concession.

Chapter 4: Provisioning

4.1 AASB 9 expected loss provisions

APRA expects a disciplined, high-quality approach to the assessment and measurement of expected losses under AASB 9.

ADIs are to consider a wide range of information when applying an expected loss approach under AASB 9, including information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of expected loss should also be reasonable and supportable.

Consideration of forward-looking information is a distinctive feature of an expected loss approach and is critical to the timely recognition of expected loss under AASB 9. ADIs are expected to employ sound judgement. APRA expects that an ADI's consideration of forward-looking information will be supported by a sufficient set of data.

APRA is proposing to include in the revised standard requirements for sound credit risk practices associated with the implementation and on-going application of the expected loss accounting approach. These requirements emphasise the timely recognition of provisions, so that the recognition of credit deterioration is not delayed.

The proposed requirements cover sound expected loss methodologies, adequacy of provisions, expected loss model validation and the need for commonality in the processes, systems, tools and data used to assess credit risk, measure expected loss for accounting purposes and determine expected loss for capital adequacy purposes.

4.2 Prescribed provisions

APRA's 'prescribed provisioning' framework is a long-standing and simple supervisory approach to provisioning appropriate for use by small ADIs. The prescribed provisioning framework (Attachment B of the revised APS 220) applies pre-determined factors to categories of loans. Historically, APRA has been comfortable with this formulaic calculation of prescribed provisions at ADIs lacking resources to maintain their own models or bear the cost of more sophisticated accounting expertise.

Removing the prescribed provisioning option from APRA's prudential framework could strengthen small ADIs' risk management and understanding of their credit portfolio, however, it may create a regulatory burden with little meaningful change in the provisioning outcome for relevant ADIs.

Therefore, APRA is proposing to retain prescribed provisioning in the prudential framework. This is consistent with the letter to ADIs that APRA published in April 2017, which stated that

ADIs could continue to use prescribed provisioning under AASB 9, subject to accounting sign-offs.[10]

Under the accounting standards, ADIs using prescribed provisioning will still be able and required to raise provisions that relate to future, presently unidentified losses.

4.3 Regulatory treatment of provisions

4.3.1 General reserve for credit losses

The existing APS 220 includes a requirement for a general reserve (GRCL) covering expected life-time losses for all exposures. APRA considered this requirement necessary when the more limited incurred loss approach to accounting provisions was introduced in 2005. In practice, it has not been common for ADIs to raise additional provisions through the GRCL, in addition to incurred-loss accounting provisions.

The accounting standards now adopt a more forward-looking approach and require provisions to be raised as an exposure's credit quality deteriorates. APRA considers the forward-looking approach to accounting provisions removes, in principle, the need for a GRCL requirement in the prudential standard. Prudential provisions (like the GRCL) are considered unnecessary as provisions under accounting standards are meant to cover expected loss, including on exposures that are performing, whilst regulatory capital is intended to cover unexpected losses. As such, APRA proposes to remove the GRCL requirement from APS 220.

4.3.2 Eligibility of provisions in regulatory capital

Broadly, exposures associated with an identified loss are considered non-performing and therefore, the corresponding provisions should not form part of regulatory capital. In practice, there will also be some exposures classified as 'significantly deteriorated' where losses have not materialised but external factors suggest potential for future losses. Therefore provisions for certain 'significantly deteriorated' exposures may be included in Tier 2 Capital, subject to the existing limits, as detailed in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111).

The following diagram illustrates APRA's proposed regulatory treatment of provisions, which is consistent with APRA's treatment as set out in its letter to industry in July 2017:[11]

[10] APRA Letter: *Prescribed provisioning and AASB 9 Financial Instruments*, 21 April 2017.

[11] APRA Letter: *AASB 9 Financial Instruments,* 4 July 2017.

Table 4: Regulatory treatment of provisions

Credit quality	High	Deterioration	Low
Asset classification	Performing	Significantly deteriorated Restructured	Non-performing Restructured
Accounting provisions	Stage 1 (12 months expected loss)	Stage 2 (Life-time expected loss)	Stage 3 (Life-time expected loss)*

*Stage 3 aligns with the regulatory definition of default.

Regulatory treatment - Standardised Approach**	Eligible for inclusion in Tier 2 Capital (up to 1.25% of credit risk-weighted assets (RWA))	Not eligible for inclusion in regulatory capital

**Stage 2 provisions may be eligible for inclusion in Tier 2 Capital if held against future, presently unidentified losses. For prescribed provisioning, all prescribed provisions are not eligible for inclusion in regulatory capital.

Assets	*Non-defaulted*	*Defaulted*
Regulatory treatment - Internal Ratings-based (IRB) Approach***	Excess of eligible provisions over expected loss for non-defaulted assets may be included in Tier 2 Capital (up to 0.6% of credit RWA)	Not eligible for inclusion in regulatory capital

***Under the IRB Approach, eligible provisions and expected loss are as defined in APS 113.

Chapter 5: Supervisory discretion to impose limits and other measures

5.1 Supervisory limits

APRA is proposing to include in the revised standard a discretion for APRA to undertake appropriate steps to address risks where APRA considers an ADI is taking excessive credit risk relative to its financial or operational capacity to absorb that risk. This may include consideration of limits on particular exposures or categories of exposures including, but not limited to, limits on growth or limits on the share of the ADI's portfolio, or may require the ADI to cease a particular type of lending or credit activity.

Where APRA considers that there is an excessive level or growth in higher risk lending or credit activity more broadly, APRA is also proposing to include in the revised standard a discretion to set limits on particular types of lending, including but not limited to, the share of lending or growth rate of lending, to be complied with by all ADIs or a specified class of ADIs.

5.2 Adequacy of credit risk management and provisions

Where APRA considers an ADI's policies, processes and practices across its credit risk activities do not meet the requirements of the revised standard, or an ADI's credit risk management is otherwise deficient, APRA may require the ADI to adopt appropriate credit risk management policies, processes, and practices, amend credit risk management policies, processes and practices, or increase the levels of provisions or write-offs reported.

In the event that APRA considers an ADI's provisioning practices or levels to be deficient, it may also potentially adjust the amount of regulatory capital held by an ADI.

5.3 Special purpose engagements

APRA is proposing to include in the revised standard the ability to require an ADI to appoint an independent party to review and provide a report to APRA on all or a particular aspect of the ADI's credit risk management, including provisioning practices. APRA may set the terms of the review, and the appointment of the independent party and provision of the report would be at the ADI's expense.

The proposals outlined in this chapter are intended to make the exercise of supervisory discretion and other measures more transparent and enforceable. Notwithstanding, they remain representative of actions that APRA have or may take as part of routine supervisory intervention.

Chapter 6: Consultation

6.1 Request for submissions

APRA invites written submissions on the proposals set out in this Discussion Paper.

Written submissions should be sent to ADIpolicy@apra.gov.au by 28 June 2019 and addressed to:

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

6.2 Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence.

Automatically generated confidentiality statements in emails do not suffice for this purpose.

Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA).

APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the Australian Prudential Regulation Authority Act 1998 and will therefore be exempt from production under the FOIA.

6.3 Request for cost-benefit analysis information

APRA requests that all interested stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any increases or decreases to the compliance costs incurred by businesses as a result of APRA's proposal.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: https://rbm.obpr.gov.au/home.aspx.

Respondents are requested to use this methodology to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake regardless of regulatory requirements in their ordinary course of business.

6.4 Consultation questions

Submissions are welcome on all aspects of the proposals in this discussion paper.

In addition, specific areas where feedback on the proposed direction would be of assistance to APRA in finalising its proposals are outlined in the table below.

Table 5: Consultation questions

Asset classification	Are there material differences between the proposed classification of exposures for prudential reporting purposes and the classification of exposures for each credit risk stage under AASB 9?
Non-performing exposures	What is the impact of including exposures that are 90 calendar days or more past-due and well secured as non-performing for prudential reporting purposes?
Restructured exposures	Does a 6-month or 12-month timeframe to return a restructured exposure to performing status provide a better indication of a borrower's likeliness to repay? Please provide any relevant data on the extent to which restructured exposures have (re)fallen into arrears after the 6-month requirement.

Attachment A: Policy options and estimated comparative net benefits

APRA is considering three policy options as set out below. Also set out is APRA's preliminary analysis of the costs and benefits of each option.

Any information provided in response to the request for cost-benefit information will be used to quantify the change in regulatory burden using the Government's Regulatory Burden Measurement Tool and inform APRA's determination of the net benefits of the options.

Table 6: Policy options

Option 1	No change to the existing APS 220.
Option 2	A narrow update of APS 220 to reflect Basel guidance and AASB 9.
Option 3	A broader update of APS 220 to reflect best practice credit risk management expectations, including the relevant recommendations of the Royal Commission, Basel guidance and AASB 9.

Option 1 – No change to the existing APS 220

Under this option, ADIs would not incur any additional compliance costs. However, the potential costs of this option may be high, but long-term and latent as they are not immediately discernible.

It is likely that ADIs' credit risk management may be adversely affected if best practice credit risk management expectations, including the relevant recommendations of the Royal Commission, are not reflected in the standard. Although APRA's previous pronouncements and APG 223 remain relevant, they do not create enforceable requirements.

Peer group comparisons with banks in other jurisdictions would remain difficult since regulators in these jurisdictions are likely to take account of Basel guidance as the basis for their regulatory reporting.

The existing standard would continue to reflect concepts and terminology commensurate with an outdated accounting standard. This is likely to create some confusion for ADIs and APRA, particularly in relation to provisioning.

Option 2 – A narrow update of APS 220 to reflect Basel guidance and AASB 9

Under this option, ADIs would incur additional compliance costs.

Strengthening the prudential standard to clarify key terms and reflect the new accounting standard would provide greater clarity and transparency for ADIs and APRA.

An update to APS 220 to reflect accounting standard changes is not expected to have any significant impact. ADIs are already required to comply with AASB 9 for reporting periods beginning on or after 1 January 2018.

This option does not have any particular impact on regulatory capital and would enhance international comparability of ADI reporting. It would also provide clarity in mapping provisions to their regulatory treatment.

Compliance costs include those associated with regulatory reporting requirements. The additional cost under the second option involve an update to reporting forms which will require some system changes. APRA considers that each ADI would have the existing data to complete updated reporting forms and that any system changes would be immaterial in regard to existing infrastructure.

However, similar to the first option, it is likely that ADIs' credit risk management may be adversely affected if best practice expectations, including the relevant recommendations of the Royal Commission, were not reflected in the standard.

Option 3 – A broader update of APS 220 to reflect best practice credit risk management expectations, including the relevant recommendations of the Royal Commission, Basel guidance and AASB 9

Under the third option, it is likely that ADIs' credit risk management would be enhanced if best practice expectations, including the relevant recommendations of the Royal Commission, were reflected in the standard. Overall credit quality would be strengthened across ADIs. Under this option, ADIs would incur additional compliance costs similar to those under the second option. Further costs associated with an update to an ADI's credit risk policies and processes to reflect best practice credit risk management expectations are likely. However, ADIs are already expected to follow best practice credit risk expectations and therefore embedding these as requirements in the prudential standard may not have material effects.

APRA