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TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

EXPOSURE TO THIRD PARTY LENDERS INCLUDING PEER TO PEER LENDERS

APRA has observed an increasing number of small-medium sized authorised deposit-taking institutions (ADIs) participating in, or planning to participate in, initiatives outside their traditional business models. Of particular concern, is the growing number of ADIs entering into funding arrangements with third party lenders, with many of these arrangements involving Peer to Peer (P2P) lenders.

These arrangements have the potential to give rise to higher credit risk for ADIs. In particular, ADIs do not appear to have undertaken their own credit assessment on loans underwritten by third party lenders. This gives rise to potential differences in the quality of those loans compared with loans underwritten directly by the ADI. ADIs have no direct recourse to the ultimate borrower and little to no history of how these loans have historically performed.

APRA has undertaken two data collection exercises to assess the nature and size of small-medium sized ADIs' exposures to third party lenders. A review of a sample of funding arrangements to P2P lenders was also conducted to understand the risks arising from these arrangements and ADIs' management of those risks. This letter shares some high-level observations from the thematic review and clarifies how ADIs should treat these exposures for APRA reporting purposes.

Strategic Considerations and Due-Diligence

APRA observed that some ADIs lacked a well thought through or defined strategic rationale for funding third party lenders and conducted little to no due diligence prior to committing to these arrangements. This included a lack of appropriate consideration to the setting, management and monitoring of inherent credit risks arising from these exposures.

APRA expects all ADIs to have an adequate approval process for new business initiatives that ensures risks are identified, understood and well managed. For P2P lending arrangements, this is critical given that ADIs often tend to assume all the risk of default, impairment and write-offs from the loans originated by the third party lenders. ADIs are also typically unable to liquidate/ cancel the committed funding before the maturity of the loans written and have no direct recourse to the underlying borrower.

Before entering into an arrangement with a third party lender, APRA expects an ADI to;

(i) have an approved strategy for P2P lending arrangements that is within Board approved risk appetite settings and setting out appropriate controls and review trigger events;and

(ii) perform due diligence on the proposed exposures which would include:

- a comprehensive assessment to understand the risk characteristics of the prospective and actual exposures;
- timely access to performance information on the exposures; and

- a comprehensive understanding of all structural features of the transaction.

APRA expects the due-diligence process to include a review of the lending policies and underwriting process used by the third party lenders when assessing the ability of the underlying borrowers to service their loan. In particular, this should involve identifying and considering the impacts of weaker standards compared to the ADI's own lending and underwriting criteria.

The need to critically review lending standards should also extend to the ability of the ADI to challenge ongoing changes that weaken lending policies and serviceability criteria. APRA expects that an ADI would ensure that these funding arrangements include provisions that impose obligations on the third party lender to obtain the ADI's prior consent to any material changes to underwriting standards.

Risk Appetite Metrics and Monitoring

Some ADIs have risk appetite metrics to manage and monitor exposures to individual third party lenders. APRA expects all ADIs to establish risk appetite metrics to manage concentration to individual third party lenders as well as an aggregate concentration metric reflecting all third party arrangements.

In addition, APRA expects that ADIs manage their third party lending risk exposures through the incorporation of targeted risk metrics and controls that can measure the quality and ongoing performance of the loans originated by the lenders, for example the level of arrears and write-offs on those loan portfolios. Understanding the risk profile and performance of the third party arrangement is critical in informing any potential adverse impact to the ADIs earnings, adequacy of provisions and capital position.

APRA Reporting of P2P Exposures

APRA observed an inconsistent approach in how ADIs classify P2P funding exposures (loan exposures versus investment securities). APRA reviewed the nature of the funding arrangements provided to some P2P lenders and determined that these exposures should be recorded as loan exposures in APRA returns: Reporting Form ARF 320.0 Statement of Financial Position (Domestic Books) and Reporting Form ARF 323.0 Statement of Financial Position. As individual third party lending arrangements vary, ADIs are expected to assess the appropriate reporting treatment and consult with their responsible supervisor.

APRA notes that the funding of P2P lenders by ADIs generally involves an ADI entering into an irrevocable commitment. Prudential Standard APS 221 Large Exposures (APS 221) does not distinguish between revocable and irrevocable commitments for large exposure purposes.

APRA expects ADIs to calculate their large exposures to P2P lenders as set out in the new APS 221 Attachment A paragraph 1(d), i.e. all committed exposures, drawn and undrawn.

Provisioning for P2P exposures

An ADI must report specific provisions and General Reserve for Credit Losses (GRCL) that, together, are adequate at all times to absorb credit losses in the ADI's business. APRA observed inconsistency in how ADIs apply specific provisioning methodologies for P2P exposures.

For ADIs that apply the prescribed provisioning methodology outlined in APS 220 Attachment C for Category 3 facilities, APRA expects that this methodology be extended to include exposures to P2P lenders. ADIs will also need to comply with APRA's letter to ADIs on prescribed provisioning of 21 April 2017.

For ADIs not applying prescribed provisioning, APRA expects provisions for exposures to P2P lenders to be calculated in accordance with their accounting provisioning model, as well as any GRCL top up which is necessary to comply with APS 220 requirements. ADIs will also need to comply with APRA's letter of 4 July 2017 on the regulatory treatment of provisions.

Next Steps

ADIs are required to consult with their responsible supervisor before entering into third party loan arrangements. As third party lenders have varying structures, the APRA reporting approaches outlined above may not always be appropriate to all arrangements. It is the ADI's responsibility to ensure exposures are reported correctly. APRA wishes to make it clear that we regard P2P lending as having a high risk profile and will actively adjust capital requirements if considered necessary.

Any questions regarding the issues raised in this letter can be directed to your responsible supervisor.

Yours sincerely,

Mark Adams
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Specialised Institutions Division