



## **Prudential Standard APS 112**

# **Capital Adequacy: Standardised Approach to Credit Risk**

### **Objectives and key requirements of this Prudential Standard**

This Prudential Standard requires an authorised deposit-taking institution to hold sufficient regulatory capital against its credit risk exposures.

The key requirements of this Prudential Standard are that an authorised deposit-taking institution:

- must apply risk weights to its on- and off-balance sheet exposures for capital adequacy purposes. Risk weights are broadly aligned with the likelihood of counterparty default; and
- may reduce the credit risk capital requirement for its on- and off-balance sheet exposures where the exposure is covered by eligible lenders' mortgage insurance, or an eligible credit risk mitigation technique.

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### Authority

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

### Application and commencement

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**) with the exception of:
  - (a) **foreign ADIs**; and
  - (b) **purchased payment facility providers**.
3. 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.
4. 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.
5. This Prudential Standard commences on 1 January 2022.

### 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.
7. Where this Prudential Standard provides for APRA to exercise a power or discretion, the power or discretion is to be exercised in writing.
8. In this Prudential Standard, unless the contrary intention appears, a reference to an Act, Regulations or Prudential Standard is a reference to the Act, Regulations or Prudential Standard as in force from time to time.

### Adjustments and exclusions

9. APRA may adjust or exclude a specific prudential requirement in this Prudential Standard in relation to one or more specified ADIs, authorised NOHCs or subsidiaries.

**Previous exercise of discretion**

10. An ADI must contact APRA if it seeks to place reliance, for the purposes of complying with this Prudential Standard, on a previous exemption or other exercise of discretion by APRA under a previous version of this Prudential Standard.

**Scope**

11. The following items are excluded from the scope of this Prudential Standard:
- (a) assets or investments that are required to be deducted from **Common Equity Tier 1 Capital, Tier 1 Capital or Total Capital** under *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111);
  - (b) securitisation exposures that are subject to the requirements of *Prudential Standard APS 120 Securitisation* (APS 120), excluding funding-only or synthetic securitisations for which an ADI must include the underlying exposures in the pool in its calculation of **Regulatory Capital** for credit risk under this Prudential Standard;
  - (c) liabilities of a covered bond special purpose vehicle to an issuing ADI as specified in *Prudential Standard APS 121 Covered Bonds*; and
  - (d) items that are subject to capital requirements under *Prudential Standard APS 116 Capital Adequacy: Market Risk* which do not have a counterparty credit risk exposure under *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180).

**Definitions**

12. The following expressions, when used in this Prudential Standard, have the meanings set out below:
- (a) bank – means an ADI or overseas bank;
  - (b) corporate – has the meaning given in paragraph 18 of Attachment B to this Prudential Standard;
  - (c) counterparty credit risk – means the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions, or portfolio of transactions, with the counterparty has a positive economic value at the time of default;
  - (d) credit conversion factor (CCF) – means the percentage value used to convert an off-balance sheet exposure into an on-balance sheet equivalent;
  - (e) credit protection – means the extent of credit risk transference from the party buying credit protection to the party selling credit protection under the terms of a credit derivative contract;

- (f) defaulted exposure – has the meaning given in Attachment E to this Prudential Standard;
- (g) domestic public sector entity (PSE) – has the meaning given in paragraph 6 of Attachment B to this Prudential Standard;
- (h) eligible bilateral netting agreement – means a **netting** agreement that meets the requirements set out in paragraph 9 of Attachment H to this Prudential Standard;
- (i) eligible collateral – means collateral listed in paragraphs 16 and 23 of Attachment G to this Prudential Standard;
- (j) eligible credit risk mitigation (CRM) – means any of the credit risk mitigation techniques detailed in Attachments G to J of this Prudential Standard;
- (k) loan-to-valuation ratio (LVR) – means a ratio calculated by dividing the amount of the loan by the value of the property or properties used to secure repayment;
- (l) lenders’ mortgage insurance (LMI) – means mortgage insurance that meets the requirements set out in paragraph 14 of Attachment A to this Prudential Standard;
- (m) off-balance sheet exposure – means an exposure which is within the scope of Attachment C to this Prudential Standard or APS 180;
- (n) overseas bank – means a financial institution incorporated outside of Australia, which is not an ADI and:
  - (i) has the power to accept deposits in the ordinary course of business;
  - (ii) is supervised by the bank supervisor in its home country; and
  - (iii) is subject to substantially the same prudential requirements as ADIs, which should be in accordance with the Basel framework;
- (o) over-the-counter (OTC) derivative transaction – means a customised, privately negotiated, risk-shifting agreement, the value of which is derived from the value of an underlying asset;
- (p) property exposure – has the meaning given in Attachment A to this Prudential Standard;
- (q) securities financing transaction (SFT) – means a transaction such as a repurchase agreement, reverse repurchase agreement or a securities lending and borrowing transaction where the value of the transaction depends on the market valuation of securities and the transaction is typically subject to margin agreements;

- (r) small- and medium-sized enterprise (SME) – has the meaning given in paragraph 23 of Attachment B to this Prudential Standard; and
- (s) sovereign – has the meaning given in paragraph 3 of Attachment B to this Prudential Standard.

### Key principles

13. An ADI must hold Regulatory Capital commensurate with its exposure to credit risk, based on the application of fixed risk weights and CCFs (where applicable) as set out in this Prudential Standard. Where appropriate, an ADI must use the ratings of **external credit assessment institutions (ECAIs)** to determine the **credit rating grade** and risk weight of an exposure, as set out in Attachments B and F to this Prudential Standard.
14. An ADI must establish and implement effective internal policies, processes, systems and controls to ensure that appropriate risk weights are assigned to its credit exposures.
15. An ADI may reduce its credit risk Regulatory Capital requirement through the use of LMI or eligible CRM techniques.
16. If an ADI seeks to use LMI or eligible CRM techniques to reduce its Regulatory Capital requirements, it must have established and implemented effective policies, procedures and systems that meet the requirements set out in this Prudential Standard. An ADI's policies and procedures must also address any residual risks such as legal, operational, liquidity and market risks that result from its use of CRM.

### Risk-weighting approach

#### *Risk-weighted on-balance sheet assets*

17. For the purpose of calculating its credit risk capital requirement, an ADI's risk-weighted on-balance sheet assets must equal the sum of the risk-weighted amounts of each on-balance sheet asset.
18. The risk-weighted amount of an on-balance sheet asset is calculated by multiplying the current book value of an exposure (including accrued interest or revaluations, and net of any specific provision, partial write-off or associated depreciation) by the relevant risk weight.

#### *Risk-weighted off-balance sheet exposures*

19. For the purpose of calculating its credit risk capital requirement, an ADI's risk-weighted off-balance sheet exposures must equal the sum of the risk-weighted amounts of each off-balance sheet exposure.
20. The risk-weighted amount of an off-balance sheet exposure is calculated by the following two-step process:

- (a) first, the credit equivalent amount, representing the on-balance sheet equivalent amount, must be determined according to:
  - (i) Attachment C to this Prudential Standard for any commitments;
  - (ii) Attachment G to this Prudential Standard and APS 180 for SFTs; and
  - (iii) APS 180 for OTC and exchange-traded derivative transactions, long-settlement transactions and any default fund guarantees in relation to clearing through central counterparties;
- (b) second, the resulting credit equivalent amount must be multiplied by the relevant risk weight applicable to the counterparty or exposure type.

### **Credit risk mitigation**

- 21. Where multiple CRM techniques cover a single exposure, an ADI must divide the exposure into portions covered by each CRM technique. The risk-weighted assets of each portion must be calculated separately, and then totalled. When credit protection provided by a single protection provider has differing maturities, they must also be subdivided into separate protected portions.
- 22. An ADI must not recognise additional CRM on exposures where the risk weight is mapped from an ECAI issue-specific credit rating, and that credit rating already incorporates the recognition of CRM.
- 23. An ADI must not recognise the use of CRM where the credit quality of the counterparty has a material positive correlation with the CRM technique used, or with any resulting residual risks (e.g. collateral in the form of securities issued by the counterparty to the credit exposure is considered to have a material positive correlation with the credit quality of the original counterparty).
- 24. In order for an ADI to obtain capital relief through the use of a CRM technique, all documentation must be binding on all parties and legally enforceable in all relevant jurisdictions. The ADI must have undertaken sufficient legal review to be satisfied of the legal enforceability of the CRM technique, and must undertake periodic reviews to confirm its ongoing enforceability.

### **Transition**

- 25. Mortgages secured by residential property that were originated prior to [the date of release of the final prudential standard], with no material change in loan terms and conditions subsequent to this date, do not need to satisfy the criteria set out in paragraph 5 of Attachment A to this Prudential Standard in order to be classified as standard mortgages.

## Attachment A – Risk weights for property exposures

1. A property exposure is an exposure that is secured by immovable real property. An ADI must risk-weight its property exposures according to the requirements detailed in this Attachment, with the exception of defaulted residential property exposures, which must be risk-weighted in accordance with Attachment E to this Prudential Standard.

### Standard mortgages

2. A loan must meet all of the requirements set out in paragraphs 3 to 7 of this Attachment to be classified as a standard mortgage.
3. An ADI must have unequivocal enforcements rights over the mortgaged property at all times, including a right to possession and power of sale in the event of default by the borrower.
4. An ADI's exposure must be secured by a registered first mortgage over the property, or by a registered second mortgage which satisfies the following conditions:
  - (a) the ADI must obtain the written consent of the first mortgagee for the second mortgage, and confirm the maximum outstanding amount of the loan secured by the first mortgage (including the maximum drawdown or limit of the facility) for LVR purposes;
  - (b) the ADI must ensure that the amount secured by the first mortgage cannot be increased without being subordinate to the second mortgage;
  - (c) each ADI holding a mortgage over the property must be able to exercise its power of sale over the property independently from any other ADI holding a mortgage over the property; and
  - (d) where the sale of the property is not carried out by means of a public auction, the ADI holding the first mortgage must be required to take reasonable steps to obtain a fair market value, or the best price that may be obtained in the circumstances, when exercising any power of sale (i.e. it is not possible for the ADI holding the first mortgage to sell the property on its own at a discounted value to the detriment of the second mortgagee).
5. An ADI must, prior to loan approval, appropriately document, assess and verify the ability of the borrower to meet their repayment obligations. This must, at a minimum, include:
  - (a) consideration of the impact of higher interest rates on the ability of the borrower to repay. For residential property, this must include the application of an interest rate buffer of at least [2.5] percentage points over the loan product rate, unless otherwise determined by APRA;
  - (b) the application of the assessment described in paragraph 5(a) to both a borrower's new and existing debt;



- (c) for interest-only loans for residential property, an assessment of serviceability for any future period over which principal and interest repayments apply; and
- (d) where the repayment of a commercial property loan is dependent on cash flows generated by the property through rental income, an assessment of the tenancy profile over a period up to at least one year past the maturity of the loan.

Where an ADI's assessment does not result in a positive determination of the borrower's ability to meet their repayment obligations, an ADI must classify the exposure as non-standard. For the purpose of this assessment, APRA may vary or apply additional serviceability criteria, based on broader market conditions.

- 6. An ADI must appropriately value any property offered as security in accordance with paragraph 10 of this Attachment, including a determination that any property offered as security for the loan is readily marketable. The value of the property must not depend materially on the performance of the borrower.
- 7. All of the information required at loan origination and for monitoring purposes must be accurately documented and readily accessible to the ADI, including information on the ability of the borrower to repay and on the valuation of the property.

#### **Loan-to-valuation ratio**

- 8. The components of LVR must be prudently calculated in accordance with the requirements set out in paragraphs 9 and 10 of this Attachment.
- 9. The amount of the loan includes the outstanding loan amount (including accrued interest and fees) and any undrawn committed amount (as per the requirements set out in Attachment C to this Prudential Standard), calculated gross of any provisions and other risk mitigants. If an ADI provides:
  - (a) multiple loans secured by the same property and they are sequential in ranking order (i.e. there is no intermediate interest from another ADI), the loan amounts must be aggregated and treated as a single exposure for the purpose of calculating the LVR; or
  - (b) a loan that is secured by a second mortgage, the outstanding amount of the loan must be calculated as the sum of all claims on the borrower secured by both the first and second mortgages over the same property for the purpose of calculating the LVR.

When calculating LVR, the loan amount will reduce as the loan amortises.

- 10. The value of the property must be appraised independently using prudently conservative criteria, consistent with the requirements set out in *Prudential*

*Standard APS 220 Credit Risk Management* (APS 220).<sup>1</sup> If a market value can be determined, the valuation should not be higher than the market value.<sup>2</sup> For the purpose of calculating the property value:

- (a) the value of the property at origination must be maintained, unless:
  - (i) an updated valuation is obtained as part of a new loan application process in relation to the mortgaged property;
  - (ii) an event occurs that results in a likely permanent reduction in the property's value; or
  - (iii) modifications are made to the property that unequivocally increase its value, and an updated valuation is obtained which confirms the increase in value;
- (b) where a loan is secured by multiple properties, an ADI must use the aggregate value of the mortgaged properties for the purpose of calculating LVR; however, where a residential property exposure is secured by both residential and commercial property, an ADI must only include the aggregated value of the residential properties; and
- (c) for a reverse mortgage, where a borrower has been guaranteed a minimum share in the future sale proceeds of a mortgaged property, the calculation of the LVR for regulatory purposes must be adjusted by reducing the value of the mortgaged property by the quarantined percentage share.

### **Credit risk mitigation**

11. An ADI may use eligible CRM to reduce the exposure amount of a loan, but the LVR band and applicable risk weight must be determined before the application of the relevant CRM technique.

### **Residential property**

12. A residential property exposure is an exposure predominantly secured by an immovable property that has the nature of a dwelling, and satisfies all applicable laws and regulations enabling the property to be occupied for housing purposes. Residential property includes the following exposure types:
  - (a) Owner-occupied refers to a loan for the purpose of housing, where the funds are used for a residential property that is occupied, or to be occupied, by the borrower(s) as their principal place of residence. Where the loan is for a residential property that is different to the residential property against which the loan is secured, this definition refers to the occupation status of the

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<sup>1</sup> The valuation must be done independently from the ADI's mortgage acquisition, loan processing and loan decision process.

<sup>2</sup> Where the loan is financing the purchase of property, the value of the property for LVR purposes must not be higher than the effective purchase price.

residential property for which the loan has been obtained (not the occupation status of the residential property used as security). It includes:

- (i) dwellings and residential land that are vacant while under construction, but that the borrower intends to occupy as a principal place of residence; and
- (ii) part-time residences that are the borrower's or borrowers' principal place of residence.

Where finance is to be used for more than one purpose (e.g. owner-occupied, investment or non-housing purposes), the entire amount of the finance must be classified according to the predominant purpose (i.e. the purpose for which the largest share of the funds will be used). Where there is any doubt or ambiguity about whether a loan is for an owner-occupied or investment purpose, the loan must be treated as an 'other residential mortgage' exposure.

- (b) Principal-and-interest refers to a loan on which interest is paid and principal is automatically amortised over the life of the loan. Interest-only loans that convert to principal and interest repayments at the end of the interest-only period must only be included as principal-and-interest loans in the period after this conversion has taken place.
  - (c) Other residential mortgages refers to any of the following exposures:
    - (i) mortgages for a purpose other than owner-occupation, including for investment or business purposes;
    - (ii) interest-only mortgages, where only interest is paid and no principal is automatically amortised; or
    - (iii) other mortgages that do not meet both of the criteria in paragraphs 12(a) and 12(b) of this Attachment.
13. In order to determine the appropriate risk weight for a mortgage over residential property, an ADI must classify the exposure as either a standard or non-standard loan. A standard loan is one which satisfies all of the criteria in paragraphs 3 to 7 of this Attachment. For all standard loans, an ADI must further:
- (a) classify the loan as an 'owner-occupied principal-and-interest mortgage', or as an 'other residential mortgage' in accordance with paragraph 12 of this Attachment;
  - (b) determine the LVR of the exposure in accordance with paragraphs 8 to 10 of this Attachment; and
  - (c) determine whether the mortgage is covered by eligible LMI, in accordance with paragraph 14 of this Attachment.

*Lenders' mortgage insurance*

14. If an ADI seeks to reduce its capital requirement through the application of LMI, it must ensure that the insurance:
- (a) provides cover for all losses up to at least 40 per cent of the higher of the original loan amount and outstanding loan amount; and
  - (b) is provided by an eligible lenders' mortgage insurer, which means that:
    - (i) for the purposes of Level 1 Regulatory Capital, the lenders' mortgage insurer must be regulated by APRA; and
    - (ii) for the purposes of Level 2 Regulatory Capital, in the case of overseas subsidiaries of Australian ADIs, APRA will accept the host supervisors' requirements on what constitutes an eligible lenders' mortgage insurer.

*Standard mortgage risk weights*

15. An ADI must apply the risk weights in Table 1 to its residential property exposures that satisfy all of the conditions of a standard mortgage, based on their classification as an owner-occupied principal-and-interest or other residential mortgage, the application of eligible LMI and LVR.

**Table 1 Risk weights for standard mortgages**

		Risk weight (%)					
		≤ 50	50.01 - 60	60.01 - 80	80.01 - 90	90.01 - 100	> 100
LVR (%)							
<b>Owner-occupied principal and interest mortgages</b>	<b>LMI</b>	20	25	35	45	60	80
	<b>No LMI</b>	20	25	35	55	70	85
<b>Other residential mortgages</b>	<b>LMI</b>	25	30	45	60	75	90
	<b>No LMI</b>	25	30	45	70	85	95

*Non-standard mortgage risk weights*

16. An exposure that is secured by residential property but does not meet any of the requirements set out in paragraphs 3 to 7 of this Attachment, must be classified as a non-standard mortgage.
17. The following exposures must also be classified as non-standard mortgages:

- (a) reverse mortgages, which are exposures that do not require principal and interest payments until termination of the facility;
  - (b) shared equity mortgages, where both the borrower and lender share in any gain or loss in the value of the mortgaged property; and
  - (c) loans to self-managed superannuation funds.
18. An ADI must apply the risk weights in Table 2 to its non-standard mortgage exposures, based on LVR (where applicable).

**Table 2 Risk weights for non-standard mortgages**

LVR (%)	Risk weight (%)	
	≤ 60	> 60
Reverse mortgages	50	100
All other non-standard mortgages	100	

19. A mortgage over residential property which does not meet the criteria set out in paragraph 5 of this Attachment, and consequently must be classified as a non-standard mortgage, may be reclassified as a standard mortgage where the borrower has substantially met their contractual loan repayments to the ADI continuously over the previous 36 months. Criteria defining when contractual loan repayments are substantially met must be set out in the ADI's credit policies.

### **Commercial property**

20. A commercial property exposure is a property exposure that is not secured by residential property as defined in paragraph 12 of this Attachment, and is not land acquisition, development and construction as defined in paragraphs 24 and 25 of this Attachment.

#### *Dependent on property cash flows*

21. When the servicing and repayment of a commercial property exposure is dependent on the cash flows generated by the property securing the exposure through sale or rental income, or from cash flows generated from other properties owned by the borrower, an ADI must apply the risk weights in Table 3 based on LVR. For this purpose, the standard risk weights may only be applied to those exposures that meet all of the requirements for a standard mortgage as set out in paragraphs 3 to 7 of this Attachment.

**Table 3 Risk weights for commercial property – dependent on property cash flows**

LVR (%)	Risk weight (%)		
	≤ 60	60.01 - 80	> 80
<b>Standard</b>	70	90	110
<b>Non-standard</b>	150		

*Not dependent on property cash flows*

22. When the servicing and repayment of a commercial property exposure does not meet the criteria for dependence as set out in paragraph 21 of this Attachment, an ADI must apply the risk weights in Table 4 based on LVR. The risk weights for exposures with an LVR ≤ 60 per cent may only be applied to those exposures that meet all of the requirements for a standard mortgage as set out in paragraphs 3 to 7 of this Attachment.

**Table 4 Risk weights for commercial property – not-dependent on property cash flows**

Counterparty	Risk weight (%)	
	LVR ≤ 60	LVR > 60 or non-standard
<b>Rated corporate</b>	60, or the risk weights in Table 10 of Attachment B	Risk weights in Table 10 of Attachment B
<b>All other counterparties</b>	60	According to applicable risk weight in Attachment B

23. Where an ADI has an exposure to commercial property that is used predominantly for forest or agricultural purposes, it may classify the exposure as ‘not-dependent’, unless the property has been acquired specifically for lease or resale, and the servicing of the debt is dependent on such lease or resale (or the lease or resale of other properties).

**Land acquisition, development and construction**

24. Land acquisition, development and construction (ADC) refers to property exposures where the security for the loan predominantly relates to any of the land acquisition for development and construction purposes, or development and construction of any residential or commercial property.

25. All property exposures where the predominant property security is not fully completed must be included as ADC unless:
  - (a) the property is used predominantly for forest or agricultural purposes; or
  - (b) the loan is secured by residential property under construction, or by land upon which residential property will be constructed, where the property will be the primary residence of the borrower.
  
26. An ADI may apply a risk weight of 100 per cent to its ADC exposures to residential property if the following conditions are met:
  - (a) the exposure meets all of the requirements in paragraphs 3 to 7 of this Attachment;
  - (b) where the exposure to the borrower is greater than \$5 million in aggregate, then there must be qualifying pre-sales for the underlying property greater than 100 per cent of the exposure amount;
  - (c) debt to qualifying development costs must be less than 75 per cent, where debt includes all debt facilities held by the borrower in relation to the underlying property; and
  - (d) the ADI has a policy that defines qualifying pre-sales and development costs. The policy must include an assessment process for pre-sales for all residential ADC exposures, including those below \$5 million in size.
  
27. An ADI must apply a risk weight of 150 per cent to all other ADC exposures.

## Attachment B – Risk weights for non-property exposures

1. An ADI must risk-weight all other exposures that are not property exposures according to the requirements detailed in this Attachment. Defaulted exposures must be risk-weighted in accordance with Attachment E to this Prudential Standard.
2. Where this Attachment requires an ADI to assign risk weights based on credit rating grades, an ADI must also comply with the requirements set out in Attachment F to this Prudential Standard.

### Sovereign exposures

3. A sovereign exposure includes:
  - (a) all exposures to Australian and overseas central and subnational governments, where a subnational government is defined as a government of a geographically defined part of a state which has powers to raise revenue and borrow money;
  - (b) all exposures to the Reserve Bank of Australia and overseas central banks, where a central bank is defined as an entity which is responsible for overseeing and implementing the monetary policy of a state or group of states; and
  - (c) all exposures to highly rated institutions and multilateral development banks eligible for a zero per cent risk weight.<sup>3</sup>
4. An ADI must apply the risk weights in Table 5 to its sovereign exposures, based on the credit rating grade of the sovereign, with the exception of those sovereign exposures eligible for a zero per cent risk weight under paragraph 3(c) of this Attachment.

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<sup>3</sup> For the purpose of paragraph 3(c), the following institutions may be risk-weighted at zero per cent: the Bank for International Settlements; the International Monetary Fund; the European Central Bank; the European Union; the European Stability Mechanism (ESM); the European Financial Stability Facility (EFSF); the World Bank Group comprising the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA) and the International Development Association (IDA); the Asian Development Bank (ADB); the African Development Bank (AfDB); the European Bank for Reconstruction and Development (EBRD); the Inter-American Development Bank (IADB); the European Investment Bank (EIB); the European Investment Fund (EIF); the Nordic Investment Bank (NIB); the Caribbean Development Bank (CDB); the Islamic Development Bank (IDB); the Council of Europe Development Bank (CEDB); the International Finance Facility for Immunization (IFFIm); and the Asian Infrastructure Investment Bank (AIIB).



**Table 5 Risk weights for sovereign exposures**

Credit rating grade	1	2	3	4, 5	6	Unrated
Risk weight (%)	0	20	50	100	150	100

5. Exposures to the Australian Government and Reserve Bank of Australia that are denominated and funded in Australian dollars, may be risk-weighted at zero per cent.

### Domestic public sector entities

6. Exposures to domestic public sector entities (PSEs) that do not meet the definition of a sovereign exposure must be risk-weighted in accordance with Table 6, based on the credit rating grade of the domestic PSE.

**Table 6 Risk weights for domestic PSEs**

Credit rating grade	1	2	3	4, 5	6	Unrated
Risk weight (%)	20	50	50	100	150	50

### Bank exposures

7. An exposure to a bank counterparty includes all exposures, other than equity or subordinated debt, to an ADI or overseas bank. This includes any exposures to multilateral development banks that are not eligible to be risk-weighted at zero per cent in accordance with paragraph 3(c) of this Attachment.
8. Where an ADI has an exposure to a bank and that exposure has a long-term external credit rating grade, an ADI must apply the risk weights in Table 7.

**Table 7 Risk weights for bank exposures (long-term credit rating grade)**

Credit rating grade (long-term)	1	2	3	4, 5	6	Unrated
Risk weight (%) (short-term exposure)	20	20	20	50	150	20
Risk weight (%) (long-term exposure)	20	30	50	100	150	50

9. For the purposes of Table 7, an ADI may apply the short-term exposure risk weights to its bank exposures, where the exposure:
- (a) has an original maturity of three months or less; or
  - (b) arises from the movement of goods across national borders, with an original maturity of six months or less.<sup>4</sup>
10. Where an ADI has an exposure to a bank and that exposure has a short-term external credit rating grade, an ADI must apply the risk weights in Table 8.

**Table 8 Risk weights for bank exposures (short-term credit rating grade)**

<b>Credit rating grade (short term)</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>Risk weight (%)</b>	20	50	100	150

11. If an ADI has an exposure to a bank with a short-term external credit rating that maps to a credit rating grade that requires a higher risk weight than would be assigned under Table 7 (short-term exposure), then an ADI must risk-weight the exposure in accordance with Table 8 and not Table 7.
12. If an ADI has an exposure to a bank with a short-term external credit rating that maps to a credit rating grade of 2 or 3, then all unrated short-term exposures to that counterparty must be risk-weighted at 100 per cent.
13. If an ADI has an exposure to a bank with a short-term external credit rating that maps to a credit rating grade of 4, then all unrated exposures to that counterparty, whether they are short-term or long-term exposures, must be risk-weighted at 150 per cent.

*Covered bonds*

14. An ADI may apply the risk weights in Table 9 to its covered bond exposures with an external credit rating grade, if the following conditions are satisfied:
- (a) the cover pool must only include the following assets:
    - (i) loans to, or guaranteed by, sovereigns, central banks or domestic PSEs;
    - (ii) loans to, or guaranteed by, banks that qualify for a 30 per cent or lower risk weight in accordance with paragraphs 8 to 10 of this Attachment; however, such assets cannot exceed 15 per cent of the cover pool;

<sup>4</sup> This may include on-balance sheet exposures such as loans and off-balance sheet exposures such as self-liquidating trade-related contingent items.

- (iii) residential mortgages that meet the requirements in paragraphs 3 to 7 of Attachment A to this Prudential Standard for covered bonds issued in Australia, and as defined by the relevant supervisory authority for covered bonds issued in other jurisdictions, with an LVR equal to or less than 80 per cent; and
  - (iv) commercial property mortgages that meet the requirements in paragraphs 3 to 7 of Attachment A to this Prudential Standard for covered bonds issued in Australia, and as defined by the relevant supervisory authority for covered bonds issued in other jurisdictions, with an LVR equal to or less than 60 per cent;
- (b) the nominal value of the cover pool must exceed the nominal outstanding value of the covered bond by at least 10 per cent; and
  - (c) the conditions set out in this paragraph must be satisfied at the time of issuance, and at all times throughout the remaining maturity of the covered bond.
15. An ADI must also be able to demonstrate to APRA that, at a minimum, the following information is available to the ADI on at least a semi-annual basis:
- (a) the value of the cover pool and outstanding covered bonds;
  - (b) the geographical distribution and type of cover assets, loan size, interest rate and currency risks;
  - (c) the maturity structure of assets in the cover pool and covered bonds; and
  - (d) the percentage of loans that are 90 days or more past-due.
16. Where an ADI meets all of the requirements set out in paragraphs 14 and 15 of this Attachment, it may apply the risk weights in Table 9 to its covered bond exposures with an external credit rating grade.

**Table 9 Risk weights for rated covered bond exposures**

<b>Credit rating grade</b>	<b>1</b>	<b>2, 3</b>	<b>4, 5</b>	<b>6</b>
<b>Risk weight (%)</b>	10	20	50	100

17. Where a covered bond is unrated or does not meet the requirements set out in paragraphs 14 and 15 of this Attachment, an ADI must apply the long-term exposure risk weights in Table 7.

### **Corporate exposures**

18. An exposure to a corporate counterparty includes all exposures, other than equity or subordinated debt, to incorporated entities, associations, partnerships, proprietorships, trusts, funds and other entities that do not meet the definition of

any other asset class. Exposures to financial institutions that are not banks, including insurance companies or securities companies, must be treated as corporate exposures.

19. An ADI must risk-weight its corporate exposures according to whether they are:
- (a) general corporate exposures, for which risk weights are determined by the external rating of the counterparty, or where the counterparty is unrated, the size of the counterparty, in accordance with paragraphs 20 to 26 of this Attachment; or
  - (b) specialised lending exposures, for which risk weights are determined in accordance with paragraphs 27 to 32 of this Attachment.

*General corporate – rated exposures*

20. Where an ADI has an exposure to a corporate counterparty and that exposure has a long-term external credit rating grade, an ADI must apply the risk weights in Table 10.

**Table 10 Risk weights for corporate exposures (long-term credit rating grade)**

<b>Credit rating grade (long-term)</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5, 6</b>
<b>Risk weight (%)</b>	20	50	75	100	150

21. Where an ADI has an exposure to a corporate counterparty and that exposure has a short-term external credit rating grade, an ADI must apply the risk weights in Table 11.

**Table 11 Risk weights for corporate exposures (short-term credit rating grade)**

<b>Credit rating grade (short-term)</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>Risk weight (%)</b>	20	50	100	150

22. If an ADI has an exposure to a corporate counterparty with a short-term external rating mapping to a credit rating grade of 4, then all unrated exposures to that counterparty, whether they are short-term or long-term exposures, must be risk-weighted at 150 per cent.

*General corporate – small- and medium-sized enterprise*

23. An exposure to an SME is an exposure, other than equity or subordinated debt, to a corporate counterparty with reported annual sales of less than or equal to \$75 million for the most recent financial year.<sup>5</sup>
24. An ADI must apply the risk weights in Table 12 to its unrated SME exposures.

**Table 12 Risk weights for unrated SME exposures**

	<b>Risk weight (%)</b>
Exposure is $\leq 60$ per cent of the market value of physical collateral	75
Exposure is $> 60 \leq 100$ per cent of the market value of physical collateral	85
Other SME exposures	100

25. In order to be recognised as physical collateral for the purpose of applying the risk weights in Table 12, the following criteria must be satisfied:
- (a) the collateral must consist of either motor vehicles, property<sup>6</sup> or plant, equipment and machinery;
  - (b) the collateral must be directly related to the business carried out by the obligor;
  - (c) the ADI must possess a first priority perfected security interest in the relevant collateral;
  - (d) all of the information pertaining to the collateral arrangements must be accurately documented and readily available to the ADI;
  - (e) there are well established publicly available market values for the collateral; and
  - (f) the ADI expects that it would be able to recover at least half of the current market value of the collateral in an economic downturn.

An ADI's relevant credit policies must document the assessment of physical collateral for this purpose.

<sup>5</sup> Where an ADI has an exposure to an SME that is part of a corporate group, it may be treated as an SME exposure provided the reported annual sales for the consolidated group is less than or equal to \$75 million for the most recent financial year.

<sup>6</sup> Where an exposure to an SME is secured by commercial property that is not dependent on the cash flows generated by the property, and does not qualify for a 60 per cent risk weight under paragraph 22 of Attachment A to this Prudential Standard, an ADI may risk-weight the exposure in accordance with paragraphs 23 to 25 of this Attachment.

*General corporate – other*

26. An ADI must risk-weight all other unrated general corporate exposures at 100 per cent.

*Specialised lending*

27. A corporate exposure must be classified as a specialised lending exposure if it possesses the following characteristics, either in legal form or economic substance:
- (a) the exposure satisfies the definition of object finance, project finance or commodities finance as set out in paragraph 28 of this Attachment, and is not a property exposure;
  - (b) the exposure is typically to an entity that was created specifically to finance or operate specific assets;
  - (c) other than the income that it receives from the assets being financed, the borrowing entity has little or no other material assets or activities, and therefore has little or no independent capacity to repay the obligation;
  - (d) the terms of the obligation give the ADI a substantial degree of control over the assets and the income that it generates; and
  - (e) as a result of the characteristics detailed in 27(a) to 27(d) of this paragraph, the primary source of repayment of the obligation is the income generated by the assets rather than the independent capacity of a broader commercial enterprise.
28. The specialised lending asset class includes the following three sub-classes of assets:
- (a) project finance, refers to the method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the loan;
  - (b) object finance, refers to the method of funding the acquisition of equipment where the repayment of the loan is dependent on the cash flows generated by the specific assets that have been financed and pledged or assigned to the lender; and
  - (c) commodities finance, refers to short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities, where the loan will be repaid from the proceeds of the sale of the commodity and the borrower has no independent capacity to repay the loan.
29. Where an issue-specific external rating is available for a specialised lending exposure, an ADI must apply the risk weights in Table 10.
30. An ADI must apply the risk weights in Table 13 to its unrated specialised lending exposures, including any exposures with an issuer-specific rating.

**Table 13 Risk weights for unrated specialised lending exposures**

	<b>Risk weight (%)</b>
Project finance (pre-operational phase)	130
Project finance (operational phase – high quality)	80
Project finance (operational phase – other)	100
Object and commodities finance	100

31. For the purpose of Table 13, a project finance exposure will be in the operational phase when the entity that was specifically created to finance the project has:
- a positive net cash flow that is sufficient to cover any remaining contractual obligation; and
  - declining long-term debt.
32. Within the operational phase, an ADI may further classify its project finance exposure as high quality where it is an exposure to an entity that is able to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions. The following conditions must also be met:
- the project finance entity is restricted from acting to the detriment of its creditors;
  - the project finance entity has sufficient reserve funds or other financial arrangements to cover the contingency funding and working capital requirements of the project;
  - the revenues are availability-based or subject to a rate-of-return regulation or take-or-pay contract;<sup>7</sup>
  - the project finance entity's revenue depends on one main counterparty and this main counterparty is a sovereign, domestic PSE or corporate entity with a risk weight of 80 per cent or lower;
  - the contractual provisions governing the exposure to the project finance entity provide for a high degree of protection for creditors in case of a default of the project finance entity;
  - the main counterparty, or other counterparties which similarly comply with the eligibility criteria for the main counterparty, will protect the creditors from the losses resulting from a termination of the project;

<sup>7</sup> Availability-based revenues mean that once construction is completed, the project finance entity is entitled to payments from its contractual counterparties provided that contract conditions are fulfilled.

- (g) all assets and contracts necessary to operate the project have been pledged to the creditors to the extent permitted by applicable laws; and
- (h) creditors may assume control of the project finance entity in the event of its default.

### **Retail exposures**

- 33. A retail exposure is any exposure to an individual(s) (that is, a natural person), excluding margin lending, that is not a property exposure.
- 34. An ADI must apply the risk weights in Table 14 to its retail exposures, based on the product type.

**Table 14 Risk weights for retail exposures**

	<b>Risk weight (%)</b>
Credit card exposures	75
Loans secured by motor vehicles	100
Other retail exposures	125

### **Margin lending exposures**

- 35. An ADI must apply a risk weight of 20 per cent to margin lending exposures secured by eligible financial collateral as detailed in paragraphs 16 and 23 of Attachment G to this Prudential Standard. Where a margin loan is secured by other collateral, an ADI must apply a risk weight of 100 per cent to its exposure.
- 36. Where the capital instruments of an ADI, insurance company or other financial institution are used as collateral for a margin lending exposure, and the ADI has full recourse to the borrower for the margin loan, it is not required to deduct the capital instruments from the corresponding category of Regulatory Capital.

### **Subordinated debt and equity exposures**

#### *Subordinated debt*

- 37. Subordinated debt includes any facility that is expressly subordinated to another facility, or is structurally subordinated as the obligor has insufficient cash flows or assets from its own operations to meet its debt obligations (i.e. debt issued by holding companies), or the ADI does not have a priority claim on the obligor's assets in the event of administration or insolvency.



38. An ADI must apply a risk weight of 150 per cent to its exposures to subordinated debt issued by a commercial (non-financial) entity.<sup>8</sup>
39. An ADI's exposure to subordinated debt issued by a financial institution must be deducted from the corresponding category of Regulatory Capital in accordance with Attachment D to APS 111.

### *Equity*

40. Equity exposures must be defined on the basis of the economic substance of the instrument. Equity exposures include both direct and indirect ownership interests,<sup>9</sup> whether voting or non-voting, in the assets and income of entities, including commercial enterprises and financial institutions. An instrument is considered to be an equity exposure if it meets the following criteria:
  - (a) it is irredeemable, in that the return of invested funds can be achieved only by the sale of the investment, the sale of the rights to the investment or by the liquidation of the issuer;
  - (b) it does not embody an obligation of the issuer; and
  - (c) it conveys a residual claim on the assets or income of the issuer.
41. Debt obligations and other securities, units in trusts, derivatives or other instruments structured with the intent or effect of conveying the economic substance of equity ownership must be treated as equity exposures. This includes options and warrants on equities and short positions in equity securities. In addition, if a debt instrument is convertible into equity at the option of an ADI, it should be treated by the ADI as equity on conversion. If such an instrument is convertible at the option of the issuer or automatically by the terms of the instrument, it should be treated by the ADI as equity from inception.
42. Equities that are recorded as a loan but arise from a debt/equity swap made as part of the orderly realisation or restructuring of the debt must be treated as an equity exposure.
43. Instruments with a return directly linked to equities must be treated as equity exposures. Subject to approval by APRA, an ADI may exclude these instruments from the equity asset class where they are directly hedged by an equity holding such that the position does not expose the ADI to material equity risk.
44. An ADI must risk-weight its equity exposures that are not required to be deducted from Regulatory Capital under APS 111 at:
  - (a) 250 per cent if listed on a recognised exchange; and

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<sup>8</sup> An exposure to subordinated debt which is structured with the intent or effect of conveying the economic substance of equity ownership, must be treated as an equity exposure.

<sup>9</sup> Indirect equity interests include holdings of derivative instruments tied to equity interests and holdings in corporations, partnerships, limited liability companies, trusts or other types of entities that issue ownership interests and are engaged principally in the business of investing in equity instruments.

- (b) 400 per cent if not listed on a recognised exchange.

### Physical assets under leases

45. An ADI must apply the risk weights in Table 15 to its exposures to physical assets under leases.

**Table 15 Risk exposures to physical assets under leases**

	<b>Risk weight (%) applying to the portion of aggregate lease asset exposures ≤ 10% of Tier 1 capital</b>	<b>Risk weight (%) applying to the portion of aggregate lease asset exposures &gt; 10% of Tier 1 capital</b>
Exposures to physical assets under leases	100	250

### Exposures through third-party lenders

46. Where an ADI has a credit risk exposure through a third-party, such as an online lending platform, and that third-party undertakes the credit assessment and approval of the underlying borrower under its own credit risk policies and processes, an ADI must risk-weight its exposure at 150 per cent.<sup>10</sup>

### Other exposures

47. An ADI must apply the risk weights in Table 16 to all other exposures that are not property exposures or included within one of the other asset classes specified in this Attachment.

<sup>10</sup> For the avoidance of doubt, the risk weight prescribed in this paragraph must be applied irrespective of the characterisation of the third-party counterparty or underlying borrower, i.e. an ADI must not risk-weight these exposures as corporate or retail exposures.

**Table 16 Risk weights for other exposures**

	<b>Risk weight (%)</b>
Cash owned and held at the ADI or in transit	0
Gold bullion held at the ADI or held in another ADI on an allocated basis, to the extent the gold bullion assets are backed by gold bullion liabilities	0
Cash items in the process of collection (e.g. cheques, draft and other items drawn on banks that are payable immediately upon presentation and that are in the process of collection)	20
Investments in premises, plant and equipment, and all other fixed assets	100
All other exposures not specified elsewhere	100

**Risk weight multiplier for certain exposures with currency mismatch**

48. An ADI must apply a 1.5 times multiplier to the applicable risk weight for any unhedged retail or residential property exposure to individuals, where the lending currency differs from the currency of the borrower's source of income.
49. An unhedged exposure is an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the borrower's income and the currency of the loan. A natural hedge exists where the borrower, in its normal operating procedures, receives foreign currency income that matches the currency of a given loan. A financial hedge generally includes a legal contract with a financial institution. For the purpose of the application of the multiplier, an ADI may only treat an exposure as hedged where the natural or financial hedge covers at least 90 per cent of the loan amount.

## Attachment C – Off-balance sheet commitments

1. A commitment is any arrangement that has been offered by the ADI and accepted by the client to extend credit, purchase assets or issue credit substitutes. For this purpose, an ADI is considered to have made an offer when it communicates a lending limit to a client, or potential client, in writing. An arrangement that does not advise a lending limit and solely stipulates the terms and conditions of future trades, does not constitute a commitment for this purpose.
2. A commitment includes any arrangement that can be unconditionally cancelled by the ADI at any time without prior notice to the obligor. It also includes any such arrangement that can be cancelled by the ADI if the obligor fails to meet conditions set out in the facility documentation, including conditions that must be met by the obligor prior to any initial or subsequent drawdown under the arrangement.
3. Where an ADI enters into an arrangement that meets all of the following conditions, it may be excluded from the definition of commitment:
  - (a) the ADI receives no fees or commissions to establish or maintain the arrangement;<sup>11</sup>
  - (b) the client is required to apply to the ADI for the initial and each subsequent drawdown;
  - (c) the ADI has full authority, regardless of the fulfilment by the client of the conditions set out in the facility documentation, over the execution of each drawdown;<sup>12</sup>
  - (d) the ADI's decision on the execution of each drawdown is made only after assessing the creditworthiness of the client immediately prior to drawdown. This assessment of creditworthiness must be undertaken by an independent party and, at a minimum, include confirmation of the client's good credit standing and that no material adverse information has arisen subsequent to the limit approval or the most recent credit review that would affect the client's creditworthiness;<sup>13</sup> and
  - (e) the client is a corporate counterparty that is closely monitored on an ongoing basis.
4. Where a commitment exists, an ADI must multiply the committed but undrawn amount of the exposure by the relevant CCF in Table 17, and then risk-weight the

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<sup>11</sup> The collection of fees by an ADI on behalf of a third-party service provider, such as a collateral agent, does not vitiate this condition.

<sup>12</sup> The terms of the arrangement must explicitly confer sole discretion on the ADI to control drawdown.

<sup>13</sup> For this purpose, independent party refers to a party independent of the client relationship manager. The independent party should sit within the risk function of the business unit or the centralised risk function. Operational or back office teams that perform documentary checks are not adequate for this purpose.

exposure according to the relevant requirements set out in Attachments A, B and D to this Prudential Standard.

**Table 17 CCFs**

<b>Transaction type</b>	<b>CCF (%)</b>
Direct credit substitutes	100
Sale and repurchase agreements and asset sales with recourse <sup>14</sup>	100
Lending of securities or posting of securities as collateral	100
Forward asset purchases, forward deposits and partly paid shares and securities <sup>15</sup>	100
Other off-balance sheet items that are credit substitutes	100
Unsettled securities, commodities and foreign exchange transactions accounted for at settlement date	100
Other commitments with certain drawdown	100
Note issuance and underwriting facilities	50
Performance-related contingencies	50
Other commitments	
Short-term self-liquidating trade letters of credit arising from the movement of goods <sup>16</sup>	20
Retail credit cards	50
Commitments to a sovereign, domestic PSE, bank or large corporate counterparty <sup>17</sup>	50
Commitments to other corporate counterparties, excluding SMEs	75
Commitment to any other counterparty	100
Irrevocable standby commitments under industry support arrangements	0

<sup>14</sup> These items must be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.

<sup>15</sup> These items must be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.

<sup>16</sup> For the purpose of this item, short-term means a maturity less than 12 months.

<sup>17</sup> For the purpose of this item, large corporate means a corporate entity with greater than \$750 million in total consolidated annual revenues.

## Attachment D – Unsettled and failed transactions

1. Delivery-versus-payment (DvP) transactions include any transaction settled through a system which provides for the simultaneous exchange of securities or commodities for cash, and expose an ADI to the risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at the current market price. This includes payment-versus-payment transactions.
2. An ADI must apply the risk weights in Table 18 to all DvP transactions, excluding SFTs, which remain unsettled after their due delivery dates. The amount that must be multiplied by the relevant risk weight is the positive current exposure amount of the DvP transaction, i.e. the difference between the agreed settlement price of the transaction and the current market price of the transaction where this would result in a loss to the ADI.

**Table 18 Risk weights for DvP transactions**

Number of business days after settlement date	Risk weight (%)
5 to 15	100
16 to 30	625
31 to 45	937.5
46 or more	1250

3. An ADI must hold Regulatory Capital against a non-DvP transaction which exposes the ADI to the risk of loss on the full amount of cash paid or deliverables delivered, where:
  - (a) it has paid for debt instruments, equities, foreign currencies or commodities before receiving them or it has delivered debt instruments, equities, foreign currencies or commodities before receiving payment for them; and
  - (b) in the case of a cross-border transaction, one day or more has elapsed since it made that payment or delivery.
4. An ADI must calculate the capital requirement for a non-DvP transaction as follows:
  - (a) from the business day after the ADI has made its payment or delivery for up to and including four business days after the counterparty payment or delivery is due, the ADI must treat the transaction as an exposure; and
  - (b) from five business days after the ADI has made its payment or delivery until extinction of the transaction, the ADI must apply a 1250 per cent risk weight to the value transferred plus the positive current exposure amount.

5. Where a non-DvP transaction must be treated as an exposure in accordance with paragraph 4(a) of this Attachment, an ADI may:
  - (a) apply the relevant risk weight based on the counterparty as detailed in Attachment B to this Prudential Standard; or
  - (b) where exposures are not material, apply a 100 per cent risk weight provided that all such exposures are risk-weighted consistently.

## Attachment E – Defaulted exposures

### Definition of default

1. For the purpose of this Prudential Standard, a default is considered to have occurred with regard to a particular obligor when either, or both, of the two following events have taken place:
  - (a) the ADI considers that the obligor is unlikely to pay its credit obligations to the ADI in full, without recourse by the ADI to actions such as realising available security;
  - (b) the obligor is 90 days or more past-due<sup>18</sup> on a credit obligation to the ADI.<sup>19</sup>
2. For the purpose of paragraph 1(a) of this Attachment, elements to be taken as indications of unlikelihood to pay include:
  - (a) the ADI puts the credit obligation on non-accrued status (e.g. the lending ADI no longer recognises accrued interest as income or, if recognised, makes an equivalent amount of provisions);
  - (b) the ADI makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the ADI taking on the exposure;
  - (c) the ADI consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or fees;
  - (d) the ADI has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the ADI;
  - (e) the obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of any of the credit obligations to the ADI;
  - (f) the ADI sells the credit obligation at a material credit-related economic loss; and
  - (g) the exposure is a reverse mortgage with an LVR greater than 100 per cent.
3. For retail exposures and property exposures to individuals, the definition of default may be applied at the level of a particular credit obligation, rather than at the level of the obligor. As such, default by an obligor on one obligation, does not require an ADI to treat all other obligations to the ADI as being in default.

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<sup>18</sup> Past-due is as defined in APS 220.

<sup>19</sup> An ADI is not required to treat an exposure which is 90 days past-due as defaulted where it relates to subsidiaries in jurisdictions where a different number of days past-due is set for retail or PSE exposures by the national regulator.



4. Overdrafts are considered past-due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings. Non-authorized overdrafts are considered to have a zero limit for regulatory capital purposes. An ADI must, therefore, treat days past-due as commencing once any credit is granted to an unauthorized customer and if such credit is not repaid within 90 days, the exposure must be considered to be in default.
5. If an ADI considers that a previously defaulted exposure's status is such that the triggers in the definition of default no longer apply, the ADI may treat the exposure as non-defaulted. In the case of a restructured item (refer to APS 220), that item must not be treated as non-defaulted until the restructured item has operated in accordance with non-concessional terms and conditions for a period of at least 12 months.

### **Risk weights for defaulted exposures**

6. Where an exposure is in default, an ADI must apply the risk weights in Table 19 or Table 20 to the exposure amount, net of specific provisions and partial write-offs.
7. Where an exposure is covered by eligible credit risk mitigation, an ADI may recognise this in calculating the exposure amount.

#### *Risk weights for residential property exposures*

8. An ADI must apply the risk weights in Table 19 to its defaulted residential property exposures.

**Table 19 Risk weights for defaulted residential property exposures**

	<b>Risk weight (%)</b>
Residential property with LMI	90
Residential property without LMI	100

#### *Risk weights for other defaulted exposures*

9. An ADI must apply the risk weights in Table 20 to its defaulted exposures that are not residential property exposures.

**Table 20 Risk weights for other defaulted exposures**

	<b>Risk weight (%)</b>
Specific provisions are $\geq$ 20 per cent of the outstanding exposure amount	100
Specific provisions are $<$ 20 per cent of the outstanding exposure amount	150

## Attachment F – External credit ratings

1. An ADI may only use the solicited ratings of ECAIs to determine the credit rating grades that correspond to the risk weights for counterparties and exposures.<sup>20</sup> Ratings must be used consistently for each type of exposure.
2. An ADI must only use an ECAI rating that takes into account and reflects the entire amount of credit risk exposure that the ADI has with regard to all amounts owed to it.
3. Where an ADI uses the ratings of ECAIs, it must perform due diligence to ensure that the external ratings appropriately and conservatively reflect the creditworthiness of the counterparty. If the due diligence analysis reflects higher risk characteristics than that implied by the exposure's external rating, an ADI must assign a risk weight at least one bucket higher than that determined by the external rating. Due diligence analysis must not result in the application of a lower risk weight than that determined by the external rating.
4. An ADI must not use credit ratings for one entity within a corporate group to determine the risk weight for other entities within the same group. If a rated entity has guaranteed another entity's exposure to the ADI, the guarantee may be recognised for risk-weighting purposes if the criteria set out in Attachment I to this Prudential Standard are satisfied.

### Issue-specific and issuer ratings

5. Where an ADI has an exposure with an issue-specific rating, the risk weight of the exposure must be assigned based on this rating. Where an exposure does not have an issue-specific rating, the ADI must apply the following requirements:
  - (a) where the counterparty has a specific rating for an issued debt, but the ADI's exposure is not an investment in that particular debt, a credit rating which maps to a risk weight lower than that which applies to an unrated exposure, may only be applied if the exposure ranks senior or *pari passu* in all respects to the rated debt issue. If the exposure does not rank senior or *pari passu* with the rated debt issue, then the ADI must treat the exposure as unrated and apply the corresponding risk weight;
  - (b) where the counterparty has an issuer rating, only senior exposures to that counterparty may be assigned a risk weight that corresponds to the issuer rating. If either the issuer or a single issue has a rating grade that maps to a risk weight higher than that applied to unrated exposures, then an exposure to that counterparty which ranks *pari passu* or is subordinated to either the senior unsecured issuer rating or the exposure with a low credit rating grade must be assigned the same risk weight as is applicable to the low credit rating grade; and

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<sup>20</sup> A solicited rating is a rating that has been initiated and paid for by the issuer or rated counterparty or a commercial associate of the issuer or rated counterparty.

- (c) where the counterparty has a specific high-quality rating that only applies to a limited class of liabilities, this rating may only be used for exposures that fall within that class.

### Multiple assessments

6. Where a counterparty has multiple ECAI general issuer ratings or where an issue has multiple ECAI issue-specific ratings, and these ratings correspond to multiple credit rating grades, an ADI must apply the following requirements:
- (a) where there are two ratings that correspond to different credit rating grades, the credit rating grade that corresponds to the higher risk weight must be used; or
- (b) where there are three or more ratings that correspond to different credit rating grades, the credit rating grades corresponding to the two lowest risk weights must be applied and the higher of those two risk weights must be used.

### Domestic and foreign currency exposures

7. An ADI must not use an ECAI rating that refers to an exposure denominated in a particular currency to derive the credit rating grade for another exposure to the same counterparty if that exposure is denominated in another currency.

### Mapping of credit rating grades

8. Where the ECAI is S&P Global Ratings, Moody's or Fitch Ratings, ratings must be mapped in accordance with Table 21 and Table 22.

**Table 21 Recognised long-term ratings and equivalent credit rating grades**

Credit rating grade	S&P Global Ratings	Moody's	Fitch Ratings
1	AAA AA+ AA AA-	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-
2	A+ A A-	A1 A2 A3	A+ A A-
3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-

4	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-
5	B+ B B-	B1 B2 B3	B+ B B-
6	CCC+ CCC CCC- CC C D	Caa1 Caa2 Caa3 Ca C	CCC+ CCC CCC- CC C D

**Table 22 Recognised short-term ratings and equivalent credit rating grades**

<b>Credit rating grade</b>	<b>S&amp;P Global Ratings</b>	<b>Moody's</b>	<b>Fitch Ratings</b>
1	A-1	P-1	F-1
2	A-2	P-2	F-2
3	A-3	P-3	F-3
4	Others	Others	Others

## Attachment G – Collateralised transactions

1. An ADI that lends securities or posts collateral must calculate capital requirements for:
  - (a) the credit risk or market risk of the securities, if this remains with the ADI; and
  - (b) the counterparty credit risk arising from the risk that the borrower of the securities may default.

A capital requirement must be applied on both sides of a transaction.

2. An ADI may only reduce its Regulatory Capital requirement where it has a credit exposure (or potential exposure) that is hedged in whole, or in part, by eligible collateral posted by a counterparty (or by a third-party on behalf of the counterparty), in accordance with the requirements set out in this Attachment.
3. An ADI must select either the simple approach or the comprehensive approach and apply that approach consistently to all of its banking book exposures that are secured by eligible collateral.
4. For trading book exposures, an ADI must use the comprehensive approach where collateral is pledged against counterparty credit risk exposures.
5. For collateralised over-the-counter transactions, exchange-traded derivatives and long settlement transactions, ADIs must use either the adjusted current exposure method (adjusted CEM) or standardised approach for counterparty credit risk, in accordance with the requirements set out in APS 180.
6. Where an ADI acting as an agent in a SFT provides a guarantee that the third-party will perform its obligations, the risk to the ADI is the same as if the ADI had entered into the transaction as the principal. In such circumstances, the ADI must calculate regulatory capital as if it were the principal.

### Minimum conditions for collateralised transactions

7. There must be a contract between the ADI and the party lodging the collateral which establishes the ADI's direct, explicit, irrevocable and unconditional recourse to the collateral. In the case of cash collateral, this may include a contractual right of set-off on credit balances, but a common law right of set-off is insufficient on its own to satisfy this condition.
8. An ADI must take all steps necessary to obtain and maintain an enforceable security interest in the collateral. The legal mechanism by which collateral is pledged or transferred must allow the ADI the right to liquidate or take legal possession of the collateral in a timely manner. An ADI must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed.

9. In the event of the counterparty's default, any requirement on the ADI to serve notice on the party lodging the collateral must not unnecessarily impede the ADI's recourse to the collateral.
10. Where the collateral is held by a custodian or a third-party, the ADI must take reasonable steps to ensure that the custodian or third-party segregates the collateral from other assets.
11. Where the collateral is lodged with an overseas branch of an ADI, the branch holding the collateral must be bound to act in accordance with the agreement between the ADI and the party lodging the collateral.
12. Where the collateral is lodged by a third-party, that third-party must indemnify or guarantee the performance of the borrower's obligations (or those of the party on which a claim is held) to the ADI. The ADI must ensure that the indemnity or guarantee is legally enforceable (i.e. that it will not fail for lack of consideration).
13. An ADI must ensure that sufficient resources are devoted to the orderly operation of margin agreements with OTC derivative and securities-financing counterparties, as measured by the timeliness and accuracy of its outgoing calls and response time to incoming calls. An ADI must have collateral risk management policies in place to control, monitor and report:
  - (a) the risk to which margin agreements expose it, such as the volatility and liquidity of the securities exchanged as collateral;
  - (b) the concentration risk to particular types of collateral;
  - (c) the re-use of collateral (both cash and non-cash) including the potential liquidity shortfalls resulting from the re-use of collateral received from counterparties; and
  - (d) the surrender of rights on collateral posted to counterparties.

### **The simple approach**

14. Under the simple approach, the secured portion of an exposure may be risk-weighted according to the risk weight of the collateral. The risk weight on the collateralised portion is subject to a floor of 20 per cent, except under the conditions specified in paragraphs 18 to 20 of this Attachment. The unsecured portion of an exposure must be risk-weighted according to the risk weight applicable to the original counterparty.
15. For collateral to be recognised under the simple approach, it must be pledged for at least the life of the exposure (i.e. maturity mismatches are not permitted) and be marked-to-market and revalued with a minimum frequency of six months. The release of collateral by the lending ADI must be conditional upon the repayment of the exposure. Collateral may be reduced in proportion to the amount of the reduction in the exposure amount.

*Eligible financial collateral under the simple approach*

16. Only the following forms of collateral may be recognised as eligible collateral under the simple approach:
- (a) cash collateral (cash, certificates of deposit and bank bills issued by the lending ADI) on deposit with the ADI incurring the exposure.<sup>21</sup> Where cash on deposit, certificates of deposit and bank bills issued by the lending ADI are held as collateral at a third-party bank in a non-custodial arrangement, and are pledged or assigned to the lending ADI and the pledge or assignment is unconditional and irrevocable, the exposure amount covered by the collateral may be assigned the risk weight of the third-party bank as set out in Attachment B to this Prudential Standard;
  - (b) gold bullion;
  - (c) debt securities rated by an ECAI that have a credit rating grade of either:
    - (i) four (or better) for long-term securities issued by sovereigns;<sup>22</sup> or
    - (ii) three (or better) for short-term or long-term securities issued by other counterparties;
  - (d) debt securities not rated by an ECAI where:
    - (i) the securities are issued by a bank as senior debt and are listed on a recognised exchange;
    - (ii) all rated issues of the same seniority by the issuing bank have a long-term or short-term credit rating grade of at least three; and
    - (iii) the ADI holding the security has no information suggesting that the security justifies a rating below this level;
  - (e) senior securitisation exposures, as defined in APS 120, with an external credit rating grade of one;
  - (f) units in a listed or unlisted trust where:
    - (i) the unit price of the trust is publicly quoted on a daily basis;
    - (ii) the trust is limited to investing in the instruments detailed in paragraphs 16(a) to 16(e) of this Attachment;<sup>23</sup> and

<sup>21</sup> Cash-funded credit-linked notes issued by the ADI against exposures in the banking book that fulfil the criteria for credit derivatives detailed in Attachment J to this Prudential Standard, may be treated as cash collateralised transactions.

<sup>22</sup> When debt securities that do not have an issue-specific rating are issued by a rated sovereign, ADIs may treat the sovereign issuer rating as the rating of the debt security.

<sup>23</sup> The use of derivative instruments by a trust to hedge investments listed in paragraphs 16(a) to 16(e) of this Attachment would not prevent the listed unit trust from being recognised as eligible collateral.

- (iii) for unlisted trusts, the ADI can redeem its investment within three business days.

- 17. Resecuritisation exposures, as defined in APS 120, are not eligible financial collateral.

*Exceptions to the 20 per cent risk weight floor*

- 18. A zero per cent risk weight may be applied to collateralised transactions where the exposure and the collateral are denominated in the same currency and either:
  - (a) the collateral is cash on deposit as defined in paragraph 16(a) of this Attachment; or
  - (b) the collateral is in the form of sovereign securities eligible for a zero per cent risk weight as detailed in Attachment B to this Prudential Standard, and its market value has been discounted by 20 per cent.
- 19. SFTs that fulfil all of the following conditions may be risk-weighted at 10 per cent:
  - (a) both the exposure and the collateral are cash, or a sovereign security qualifying for a zero per cent risk weight as set out in Attachment B to this Prudential Standard;
  - (b) both the exposure and the collateral are denominated in the same currency;
  - (c) either the transaction is overnight, or both the exposure and the collateral are marked-to-market daily and are subject to daily remargining;
  - (d) following a counterparty's failure to remargin, the time between the last mark-to-market before the failure to remargin and the liquidation of the collateral is no more than four business days;
  - (e) the transaction is settled across an established settlement system for that type of transaction;
  - (f) the documentation for the transaction is standard market documentation;
  - (g) the documentation for the transaction specifies that if the counterparty fails to satisfy an obligation to deliver cash, securities or a margin call, or otherwise defaults, the transaction is immediately terminable; and
  - (h) upon any default event, regardless of whether the counterparty is insolvent or bankrupt, the ADI has an unequivocal, legally enforceable right to immediately seize and liquidate the collateral.
- 20. SFTs that fulfil all of the criteria in paragraph 19 of this Attachment, and where the counterparty to the transaction is a core market participant, may be risk-weighted at zero per cent. The following entities are considered core market participants:



- (a) the Australian Government and the Reserve Bank of Australia;
- (b) sovereigns that qualify for a zero per cent risk weight in accordance with Attachment B to this Prudential Standard;
- (c) banks;
- (d) other financial institutions (including insurance companies) eligible for a 20 per cent risk weight as set out in Attachment B to this Prudential Standard; and
- (e) qualifying central counterparties.

### **The comprehensive approach**

- 21. An ADI using the comprehensive approach must calculate its adjusted exposure to a counterparty to take into account the risk mitigating effects of any eligible collateral.
- 22. An ADI must use supervisory haircuts to adjust both the amount of the exposure (volatility-adjusted exposure amount) and the value of the collateral (volatility-adjusted collateral amount), in order to take into account possible future price fluctuations of the exposure or collateral.<sup>24</sup> Unless either side of the transaction is cash or a zero per cent haircut is applied, the volatility-adjusted exposure amount must be higher than the nominal exposure and the volatility-adjusted collateral amount must be lower than the nominal collateral value.

#### *Eligible financial collateral under the comprehensive approach*

- 23. In addition to the items listed in paragraph 16 of this Attachment, the following forms of collateral may be recognised under the comprehensive approach:
  - (a) equities (including convertible bonds) that are included in a main index or listed on a recognised exchange; and
  - (b) units in trusts that meet the conditions of paragraph 16(f) of this Attachment and that invest in equities as set out in paragraph 23(a) of this Attachment.

#### *Calculation of Regulatory Capital for collateralised transactions*

- 24. For a collateralised transaction under the comprehensive approach, and subject to paragraph 25 of this Attachment, the adjusted exposure amount is calculated as follows:

$$E^* = \max \left\{ 0, \left[ E \times (1 + H_e) - C \times (1 - H_c - H_{fx}) \right] \right\}$$

where:

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<sup>24</sup> Exposure amounts may vary where, for example, securities are being lent.

- $E^*$  = the adjusted exposure amount
- $E$  = current value of the exposure
- $H_e$  = haircut appropriate to the exposure calculated in accordance with paragraphs 30 to 32 of this Attachment
- $C$  = the current value of the collateral, adjusted for any maturity mismatch in accordance with paragraphs 26 to 29 of this Attachment
- $H_c$  = haircut appropriate to the collateral calculated in accordance with paragraphs 30 to 32 of this Attachment
- $H_{fx}$  = haircut appropriate for currency mismatch between the collateral and exposure calculated in accordance with paragraph 33 of this Attachment.

The exposure amount ( $E^*$ ) must be multiplied by the risk weight of the counterparty in accordance with Attachment B to this Prudential Standard to obtain the risk-weighted asset amount for the collateralised transaction.

25. In the case of OTC derivatives under the adjusted CEM (refer to Attachment E of APS 180),  $E \times (1 + H_e)$ , as set out in paragraph 24 of this Attachment, is replaced by the credit equivalent amount of the OTC derivative calculated in accordance with Attachment E of APS 180.

#### *Collateral maturity mismatch*

26. A maturity mismatch exists where the residual maturity of the term of lodgement of the collateral is less than the maturity of the exposure covered by the collateral.
27. Where there is a maturity mismatch, the collateral may only be recognised where the original maturity of the term of lodgement of the collateral is greater than or equal to 12 months and the residual maturity is greater than or equal to 3 months.
28. For the purpose of determining maturity:
- (a) the effective maturity of the underlying exposure must be calculated using the longest possible remaining time before the counterparty is scheduled to fulfil its obligation; and
  - (b) for the collateral, an ADI must take into account any clause or incentive within the documentation supporting the transaction that may reduce its term of lodgement so that the shortest possible effective maturity is used.
29. Where there is a maturity mismatch, an ADI must apply the following adjustment:

$$P_a = P \cdot \frac{t - 0.25}{T - 0.25}$$

where:

- $P_a$  = value of the collateral adjusted for maturity mismatch
- $P$  = collateral amount adjusted for any haircuts
- $t$  = min (T, residual maturity of the term of lodgement of the collateral) expressed in years
- $T$  = min (5, residual maturity of the exposure) expressed in years.

### Supervisory haircuts

30. An ADI must use the supervisory haircuts set out in Table 23 to calculate the appropriate haircuts for the collateral ( $H_c$ ) and exposure ( $H_e$ ). These haircuts assume daily mark-to-market, daily remargining and a 10 business day holding period.

**Table 23 Supervisory haircuts**

Credit rating grade for debt securities	Residual maturity	Sovereign <sup>25</sup>	Other issuer <sup>26</sup>	Securitisation Exposure <sup>27</sup>
1 (long- and short-term)	≤ 1 year	0.5	1	2
	> 1 year, ≤ 3 years	2	3	8
	> 3 years, ≤ 5 years		4	
	> 5 years, ≤ 10 years	4	6	16
	> 10 years		12	
2-3 (long- and short-term) and unrated bank securities <sup>28</sup>	≤ 1 year	1	2	Not eligible
	> 1 year, ≤ 3 years	3	4	
	> 3 years, ≤ 5 years		6	
	> 5 years, ≤ 10 years	6	12	

<sup>25</sup> Sovereign has the meaning given in Attachment B to this Prudential Standard.

<sup>26</sup> This includes banks, domestic PSEs and corporates.

<sup>27</sup> Securitisation exposure has the meaning given in APS 120.

<sup>28</sup> Unrated bank securities must meet the requirements set out in paragraph 16(d) of this Attachment.

	> 10 years		20
4 (long-term)	All	15	Not eligible
Main index equities (including convertible bonds) and gold		20	
Other equities and convertible bonds listed on a recognised exchange		30	
Units in trusts		Highest haircut applicable to any security in which the trust can invest	
Cash in the same currency <sup>29</sup>		0	

31. For transactions in which an ADI lends or posts non-eligible instruments, a haircut of 30 per cent must be applied to the exposure. For transactions in which an ADI borrows non-eligible instruments, no credit risk mitigation may be recognised.
32. Where the collateral is a basket of assets, the haircut on the basket must be calculated as:

$$H = \sum_i a_i H_i$$

where:

$a_i$  = the weight of the asset in the basket (as measured by units of currency)

$H_i$  = the haircut applicable to that asset.

33. An ADI must apply a haircut of 8 per cent (based on a 10 business day holding period and daily mark-to-market) for currency risk ( $H_{fx}$ ) where the exposure and collateral are denominated in different currencies.

*Adjustments for different holding periods and non-daily mark-to-market or remargining*

34. An ADI must apply the minimum holding periods and conditions in Table 24 of this Attachment to SFTs, other capital-market-driven transactions (e.g. OTC derivative transactions and margin lending) and secured lending.

<sup>29</sup> As per the eligible cash collateral requirements set out in paragraph 16(a) of this Attachment.

**Table 24 Minimum holding periods and conditions**

Transaction type	Minimum holding period (business days)	Condition
SFTs	5	Daily remargining
Other capital market transactions	10	Daily remargining
Secured lending	20	Daily revaluation

35. Under the following circumstances, an ADI must apply a higher minimum holding period:

- (a) for all netting sets where the number of trades exceeds 5,000 at any point during a quarter, an ADI must set the minimum holding period to 20 business days for the following quarter;
- (b) for netting sets containing one or more trades involving either illiquid collateral, or an OTC derivative that cannot be easily replaced, an ADI must set the minimum holding period to 20 business days. An ADI must determine both liquidity and ease of replacement in the context of stressed market conditions; and
- (c) if an ADI has experienced more than two margin call disputes on a particular netting set over the previous two quarters that have lasted longer than the applicable minimum holding period (before consideration of this provision), the ADI must use a minimum holding period that is at least double the supervisory floor for that netting set for the subsequent two quarters.

In determining the holding period, an ADI must consider whether trades or securities it holds as collateral are concentrated in a particular counterparty and, if that counterparty exited the market precipitously, whether the ADI would be able to replace its trades.

36. When remargining or revaluation is undertaken less frequently than the minimum specified in paragraph 34 of this Attachment, haircuts must be adjusted depending on the actual number of business days between remargining or revaluation using the formula detailed below. The 10 business day haircuts set out in paragraph 30 of this Attachment are the default haircuts and must be scaled up or down using the formula below:

$$H = H_{10} \sqrt{\frac{N_R + (T_M - 1)}{10}}$$

where:

$$H = \text{haircut}$$

- $H_{10}$  = 10 business day haircut for instrument as set out in Table 23
- $T_M$  = minimum holding period for the type of transaction
- $N_R$  = actual number of business days between remarking or revaluation.

37. An ADI may apply a haircut of zero to SFTs with core market participants that satisfy all of the conditions set out in paragraphs 19 and 20 of this Attachment.

*Treatment of SFTs covered by master netting agreements*

38. Where SFTs are covered by an eligible bilateral netting agreement that meets the requirements detailed in Attachment H to this Prudential Standard, an ADI that uses the comprehensive approach must apply the following formula for the purpose of calculating the exposure amount:

$$E^* = \max \left\{ 0; \sum_i E_i - \sum_j C_j + 0.4 \cdot \text{net exposure} + 0.6 \cdot \frac{\text{gross exposure}}{\sqrt{N}} + \sum_{fx} (E_{fx} \cdot H_{fx}) \right\}$$

where:

- $E^*$  = the exposure value of the netting set after risk mitigation
- $E_i$  = current value of all cash and securities lent, sold with an agreement to repurchase or otherwise posted to the counterparty under the netting agreement
- $C_j$  = current value of all cash and securities borrowed, purchased with an agreement to resell, or otherwise held by the ADI under the netting agreement

$$\text{net exposure} = \left| \sum_s E_s H_s \right|$$

$$\text{gross exposure} = \sum_s E_s |H_s|$$

- $E_s$  = the net current value of each security issuance under the netting set (always a positive value)

- $H_s$  = haircut appropriate to  $E_s$ , as set out in Table 23

$H_s$  has a positive sign if the security is lent, sold with an agreement to repurchase, or transacted in a manner similar to either securities lending or a repurchase agreement

$H_s$  has a negative sign if the security is borrowed, purchased with an agreement to resell, or transacted in a manner similar to either securities borrowing or a reverse repurchase agreement

$N$  = the number of security issues contained in the netting set (except that issuances where the value of  $E_s$  is less than one tenth of the value of the largest  $E_s$  in the netting set are not included in the count)

$E_{fx}$  = absolute value of the net position in each currency  $fx$  different from the settlement currency

$H_{fx}$  = haircut appropriate for currency mismatch of currency  $fx$ .

*Minimum haircut floors for SFTs*

39. An ADI must apply the haircut floors set out in paragraph 43 of this Attachment to the following transactions:
- (a) non-centrally cleared SFTs in which the financing against collateral other than government securities is provided to counterparties who are not supervised by a regulator that imposes prudential requirements consistent with international norms; and
  - (b) collateral upgrade transactions with the same counterparties identified in paragraph 39(a) of this Attachment. A collateral upgrade transaction is when an ADI lends a security to its counterparty and the counterparty pledges a lower quality security as collateral, thus allowing the counterparty to exchange a lower quality security for a higher quality security.
40. SFTs with central banks are not subject to the haircut floors set out in paragraph 43 of this Attachment.
41. Cash collateralised securities lending transactions may be exempted from the application of the haircut floors where:
- (a) securities are lent to the ADI at long maturities and the lender of securities reinvests or employs the cash at the same or shorter maturity, therefore not giving rise to material maturity or liquidity mismatch; or
  - (b) securities are lent to the ADI at call or at short maturities, giving rise to liquidity risk, but the lender of the securities reinvests the cash collateral into a reinvestment fund or account subject to regulations or regulatory guidance meeting the global minimum standards for reinvestment of cash collateral by securities lenders. For this purpose, an ADI may rely on representations by securities lenders that their reinvestment of cash collateral meets the minimum standards.
42. An ADI that lends securities is exempt from the haircut floor for collateral upgrade transactions if it is unable to re-use, or provides representations that it does not and will not re-use, the securities received as collateral against the securities lent.
43. An ADI must apply the haircut floors in Table 25 to SFTs described in paragraph 39 of this Attachment which do not meet the requirements for exemption under paragraphs 40 to 42 of this Attachment.

**Table 25 Haircut floors for SFTs**

Residual maturity of collateral	Haircut level (%)	
	Corporate and other issuers	Securitized products
≤ 1 year debt securities, and floating rate notes	0.5	1
> 1 year, ≤ 5 year debt securities	1.5	4
> 5 year, ≤ 10 year debt securities	3	6
> 10 year debt securities	4	7
Main index equities	6	
Other assets within the scope of the framework	10	

44. In-scope SFTs which do not meet the haircut floors must be treated as unsecured loans to counterparties.
45. To determine whether an SFT (or a netting set of SFTs in the case of portfolio-level haircuts) must be treated as an unsecured loan to a counterparty, an ADI must determine the following inputs:
- the collateral haircut ( $H$ ); and
  - the haircut floor ( $f$ ).
46. For a single in-scope SFT not included in a netting set, the values of  $H$  and  $f$  must be computed as:
- for a single cash-lent-for-collateral SFT,  $H$  is the amount of collateral received and  $f$  is the floor as per Table 25 of this Attachment. For the purpose of this calculation, collateral that is called by either counterparty may be treated as collateral received from the point in time at which it is called; and
  - for a single collateral-for-collateral SFT, lending collateral A and receiving collateral B,  $H$  is still the amount of collateral received, but the effective floor of the transaction must be calculated as:

$$f = \left[ \left( \frac{1}{1+f_A} \right) / \left( \frac{1}{1+f_B} \right) \right] - 1 = \frac{1+f_B}{1+f_A} - 1$$

which must be compared to the effective haircut of the transaction:



$$\frac{C_B}{C_A} - 1$$

47. For a netting of SFTs, the effective portfolio floor of the transaction must be calculated as:

$$f_{Portfolio} = \left[ \left( \frac{\sum_s E_s}{\sum_s E_s \times (1 + f_s)} \right) \middle/ \left( \frac{\sum_t C_t}{\sum_t C_t \times (1 + f_t)} \right) \right]^{-1}$$

where:

$E_s$  = the net position in each security (or cash)  $s$  that is net lent

$C_t$  = the net position that is net borrowed

$f_s$  = the haircut floor for the securities that are net lent

$f_t$  = the haircut floor for the securities that are net borrowed.

The portfolio will not breach the floor where:

$$\frac{\sum C_t - \sum E_s}{\sum E_s} \geq f_{Portfolio}$$

48. If the portfolio haircut breaches the floor, then the netting set of SFTs is subject to the treatment in paragraph 44 of this Attachment. This treatment must be applied to all trades for which the security received appears in Table 25 and for which, within the netting set, the ADI is also a net receiver in that security. For the purpose of this calculation, collateral that is called by either counterparty may be treated as collateral received from the moment that it is called.

## Attachment H – Netting

1. An ADI may reduce its exposure amount, for the purpose of calculating Regulatory Capital, through the application of close-out netting or netting by novation, in accordance with the requirements set out in this Attachment.
2. An ADI that chooses to net transactions must do so on a consistent basis, and must apply netting to all transactions in both the banking book and trading book that are covered by a netting agreement.
3. An ADI that applies netting for CRM purposes must have a netting policy that, at a minimum, addresses the requirements in this Prudential Standard. The netting policy must apply to all transactions subject to netting and include systems and controls for:
  - (a) monitoring and reporting netted transactions on a gross and net basis; and
  - (b) monitoring and managing roll-off risk and termination risk.
4. An ADI that nets transactions for CRM purposes must maintain adequate records to support the application of the netting agreement.

### Use of netting

5. For CRM purposes, an ADI may only net the following types of transactions:
  - (a) on-balance sheet loans and deposits;
  - (b) SFTs; and
  - (c) OTC derivative transactions (across both the banking and trading books) with a single counterparty. This may include netting across different types of derivatives, but not across derivatives and SFTs.

For the purposes of this Attachment, an ADI must not recognise payments netting, which is a process designed to reduce operational costs and risks associated with daily settlement of transactions.

6. An ADI may only net internal transactions between the banking book and trading book if:
  - (a) the netted transactions are marked-to-market daily, where applicable;<sup>30</sup> and
  - (b) any collateralised instruments used in the transactions comply with the criteria for eligible collateral in the banking book as detailed in Attachment G to this Prudential Standard.

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<sup>30</sup> The holding period for the haircuts depends, as for other SFTs, on the frequency of margining.

**On-balance sheet netting**

7. An ADI may only use the net exposures of loans and deposits as the basis for its capital adequacy calculation where it:
  - (a) has a well-founded basis for concluding that the netting or offsetting agreement is legally enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt;
  - (b) is able at any time to determine those assets and liabilities with the same counterparty that are subject to the netting agreement;
  - (c) monitors and controls its roll-off risks; and
  - (d) monitors and controls the exposures on a net basis.
8. When all of the conditions in paragraph 7 of this Attachment are satisfied, an ADI may use the net exposure of loans and deposits in accordance with the formula in paragraph 24 of Attachment G to this Prudential Standard, where:
  - (a) assets (loans) must be treated as exposures;
  - (b) liabilities (deposits) must be treated as collateral;
  - (c) supervisory haircuts as per Table 23 and paragraph 33 of Attachment G to this Prudential Standard must be applied where relevant;
  - (d) a 10 business day holding period applies when daily mark-to-market is conducted. The minimum haircut numbers must be scaled up in accordance with paragraph 36 of Attachment G to this Prudential Standard where relevant; and
  - (e) where there is a maturity mismatch, this must be adjusted for in accordance with paragraphs 26 to 29 of Attachment G to this Prudential Standard.

**Eligible bilateral netting agreement**

9. An eligible bilateral netting agreement, which includes a master netting agreement, is a netting agreement with a counterparty which:
  - (a) provides the non-defaulting party the right to terminate and close out, in a timely manner, all transactions under the netting agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;<sup>31</sup>

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<sup>31</sup> In some countries, there are provisions for the authorities to appoint an administrator to a troubled bank. Under statutory provisions applying in those countries, the appointment of an administrator may not constitute grounds for the triggering of netting agreements. Such provisions do not prevent the recognition of affected netting agreements for the purposes of this Prudential Standard, provided that a netting agreement can still take effect in the event the bank under administration does not meet its obligations under transactions as they fall due.

- (b) provides for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it, so that only a single net amount is owed by one party to the other;<sup>32</sup>
- (c) allows for the prompt liquidation or set-off of collateral upon the event of default;
- (d) is legally enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt; and
- (e) does not include a walkaway clause (i.e. any clause which, in the event of default of a counterparty, permits a non-defaulting counterparty to make limited payments only, or no payments at all, to a defaulting party, even if the defaulting party is a net creditor).

### Legal enforceability

10. The requirement to ensure that a netting agreement is legally enforceable for both on-balance sheet netting and eligible bilateral netting agreements, requires an ADI to:
  - (a) obtain a written and reasoned legal opinion that concludes that in the event of default, liquidation, bankruptcy or other similar circumstances of a party to the netting agreement, the relevant courts and authorities would find the ADI's exposure is limited to the single net sum determined in the netting agreement under:
    - (i) the law of the jurisdiction in which the counterparty is incorporated, formed or resides (in the case of a natural person), and if a foreign branch of the counterparty is involved, the law of the jurisdiction in which the branch is located;
    - (ii) the law that governs the individual transactions involved; and
    - (iii) the law that governs any contract or agreement necessary to give effect to the netting;
  - (b) have policies and procedures in place to ensure that the legal enforceability of netting agreements are kept under review in response to possible changes in relevant laws.
11. An ADI must not recognise a netting agreement for the purposes of CRM if there is any doubt as to its legal enforceability. Where an ADI becomes aware that a regulator or supervisor of a counterparty has given notice that it is not satisfied that netting is enforceable under the laws of the regulator's or supervisor's home country, it must not recognise the netting agreement for CRM purposes regardless of any legal opinion obtained by the ADI.

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<sup>32</sup> For forwards, swaps, options and similar derivative contracts, this will include the net sum of the positive and negative mark-to-market values of individual transactions.

## Attachment I – Guarantees

1. Where an ADI's exposure to a counterparty is covered by a guarantee from an eligible guarantor, an ADI may substitute the risk weight of the counterparty for the risk weight of the guarantor for the covered portion of the exposure.<sup>33</sup> The uncovered portion of the exposure must be risk-weighted according to the risk weight applicable to the original counterparty.

### Minimum requirements

2. In order to be recognised as eligible CRM, a guarantee must satisfy the following requirements:
  - (a) it must represent a direct claim on an eligible guarantor;
  - (b) it must be an explicitly documented obligation assumed by the guarantor;
  - (c) it must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;
  - (d) it must be irrevocable, except in the case of non-payment by a protection purchaser of money due in respect of the credit protection contract. The guarantee must not contain any clauses that would allow the guarantor to unilaterally cancel the cover of the guarantee, or that would increase the effective cost of cover as a result of deteriorating credit quality in the guaranteed exposure;<sup>34</sup>
  - (e) it must be unconditional. The guarantee must not include any clauses that are outside the direct control of the ADI, or that could prevent the guarantor from being obliged to pay out in a timely manner in the event that the underlying counterparty fails to make the payment(s) due;
  - (f) on the qualifying default or non-payment of the counterparty, the ADI must have the capacity to pursue, in a timely manner, the guarantor for any monies outstanding under the documentation governing the transaction. The ADI must have the right to receive payment from the guarantor without first having to take legal action in order to pursue the counterparty for payment; and
  - (g) it must cover all types of payments the underlying obligor is expected to make under the documentation governing the transaction. Where a guarantee covers payment of principal only, interest and other amounts not covered by the guarantee must be treated as uncovered.

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<sup>33</sup> Guarantees that provide partial coverage whereby the ADI and guarantor share losses on a *pro rata* basis are eligible for the same recognition.

<sup>34</sup> While the requirement for irrevocability does not require that the guarantee and the exposure be maturity matched, the guarantor must not have the ability to change the agreed maturity *ex post*.

**Eligible guarantors**

3. An ADI must only recognise guarantees provided by the following entities when they have a lower risk weight than the counterparty:
  - (a) sovereigns;
  - (b) banks;
  - (c) other entities that are externally rated, where credit protection is provided to a non-securitisation exposure. This includes guarantees provided by parent, subsidiary and affiliate companies where they have a lower risk weight than the obligor; and
  - (d) where credit protection is provided to a securitisation exposure, other entities with a credit rating grade of three or better and that were externally rated two or better at the time the credit protection was provided. This also includes guarantees provided by parent, subsidiary and affiliated companies where they have a lower risk weight than the obligor.
4. A claim that is indirectly guaranteed by the Australian Government (i.e. the Commonwealth's guarantee of the entity that provides the guarantee) may be treated as guaranteed by the Australian Government provided that:
  - (a) the indirect guarantee covers all credit risk elements of the claim;
  - (b) both the original guarantee and the indirect guarantee meet all the requirements detailed in paragraph 2 of this Attachment, except that the indirect guarantee need not be direct and explicit to the original claim; and
  - (c) the ADI is satisfied that the cover of the indirect guarantee is robust and there is no historical evidence to suggest that the coverage of the indirect guarantee is not equivalent to that of a direct guarantee of the Australian Government.
5. Letters of comfort do not qualify as eligible guarantees for CRM purposes.

**Materiality thresholds**

6. Where a guarantee provides for a materiality threshold on payments below which no payment will be made in the event of loss, it is equivalent to a retained first loss position and must be deducted from Common Equity Tier 1 Capital in accordance with APS 111. This deduction will be capped at the amount of capital the ADI would be required to hold against the full value of the underlying exposure.

**Proportional and tranching cover**

7. Where there is partial coverage of an exposure by a guarantee and the covered and uncovered portions are of equal seniority (i.e. the ADI and the guarantor share losses on a *pro rata* basis), capital relief will be afforded on a proportional basis.

This means that the covered portion of the exposure will receive the treatment applicable to eligible guarantees with the remainder treated as uncovered.

8. Where there is partial coverage of an exposure by a guarantee and there is a difference in seniority between the covered and uncovered portions of the exposure, then the arrangement is considered to be a synthetic securitisation and is subject to the requirements set out in APS 120.

### Currency mismatch

9. A currency mismatch exists where a guarantee is denominated in a different currency from that in which the exposure is denominated. In this case, the amount of the exposure deemed to be protected ( $G_a$ ) must be reduced by the application of a haircut ( $H_{fx}$ ) as follows:

$$G_a = G \times (1 - H_{fx})$$

where:

$G$  = nominal amount of the guarantee

$H_{fx}$  = haircut appropriate for the currency mismatch between the guarantee and the underlying exposure.

10. Where there is a currency mismatch, an ADI must apply a haircut of 8 per cent (based on a 10 business day holding period and daily marking-to-market). The haircut must be adjusted depending on the actual frequency of revaluation of the currency mismatch, in accordance with paragraph 36 of Attachment G to this Prudential Standard.

### Maturity mismatch

11. A maturity mismatch exists where the residual maturity of a guarantee is less than the maturity of the exposure covered by the guarantee.
12. Where there is a maturity mismatch, a guarantee may only be recognised as eligible CRM where the original maturity of the guarantee is greater than or equal to 12 months and the residual maturity is greater than or equal to 3 months.
13. Where credit protection provided by a single guarantor to the same underlying exposure has different maturities, an ADI must divide the exposure into separate covered portions for risk-weighting purposes.
14. For the purposes of determining maturity:
  - (a) the effective maturity of the underlying exposure must be calculated using the longest possible remaining time before the counterparty is scheduled to fulfil its obligation; and
  - (b) for the guarantee, an ADI must take into account any clause or incentive within the documentation supporting the transaction that may reduce its maturity so that the shortest possible effective maturity is used.

15. Where there is a maturity mismatch, an ADI must apply the following adjustment:

$$P_a = P \cdot \frac{t - 0.25}{T - 0.25}$$

where:

$P_a$  = value of the guarantee adjusted for maturity mismatch

$P$  = guarantee amount adjusted for any haircuts (in which case,  $P = G_a$  as determined in paragraph 9 of this Attachment)

$t$  = min (T, residual maturity of the guarantee) expressed in years

$T$  = min (5, residual maturity of the exposure) expressed in years.



## Attachment J – Credit derivatives

### Purchased credit protection

1. Where an ADI purchases credit protection through an eligible credit derivative, it may substitute the risk weight of the counterparty with the risk weight of the credit protection seller for the covered portion of the exposure.<sup>35</sup> The uncovered portion of the exposure must be risk-weighted according to the risk weight applicable to the original counterparty.
2. For the purposes of CRM, eligible credit derivatives are limited to:
  - (a) single-name credit-default swaps; and
  - (b) certain total-rate-of-return swaps.

Where an ADI purchases credit protection through a total-rate-of-return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection must not be recognised.

3. Cash-funded credit linked notes issued by an ADI against exposures in the banking book that satisfy the minimum requirements for credit derivatives as detailed in this Attachment (with the exception of eligible credit protection providers set out in paragraph 9 of this Attachment) may be treated as cash-collateralised transactions under Attachment G to this Prudential Standard.
4. Where an ADI buys credit protection through a credit derivative that forms part of a synthetic securitisation, this Attachment must be read in conjunction with the requirements detailed in APS 120.

### *Minimum requirements*

5. In order to be recognised as eligible CRM, a credit derivative must satisfy the following requirements:
  - (a) it must represent a direct claim on the protection seller;
  - (b) it must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;
  - (c) it must be irrevocable, except in the case of non-payment by a protection purchaser of money due in respect of the credit protection contract. The credit derivative contract must not include any clause that would allow the protection seller to unilaterally cancel the protection of the credit derivative,

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<sup>35</sup> Credit derivatives that provide partial coverage whereby the ADI and the credit protection seller share losses on a *pro rata* basis are eligible for the same recognition.

or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure;<sup>36</sup>

- (d) it must be unconditional. The credit derivative contract must not include any clauses that are outside the direct control of the ADI, and the credit events specified in the contract must not prevent the protection seller from being obliged to pay out in a timely manner in the event that the obligor to the underlying exposure fails to make the due payment(s);
- (e) the credit events specified under the terms of the credit derivative contract must, at a minimum, cover:
  - (i) the failure to pay an amount due under the terms of the underlying exposure that is in effect at the time of such failure;
  - (ii) the bankruptcy, insolvency or inability of the obligor of the underlying exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as those debts become due, or analogous events; and
  - (iii) subject to paragraph 6 of this Attachment, the restructuring of the underlying exposure, including any forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. write-off, specific provision or other similar debit to the profit and loss account of the ADI).
- (f) it must not terminate prior to the expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay;
- (g) where the credit derivative is based on cash settlement, the ADI must have a robust valuation process in order to reliably estimate losses on the reference obligation specified in the credit derivative contract, including a defined period for obtaining post credit event valuations of the reference obligation;
- (h) where an ADI purchases credit protection and an existing credit exposure of the ADI is the deliverable obligation under the credit derivative contract, the terms of the underlying exposure must allow for its transfer to the protection seller.<sup>37</sup> If the protection purchaser's right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld; and

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<sup>36</sup> While the requirement for irrevocability does not require that the credit derivative and the exposure be maturity matched, the credit protection provider must not have the ability to change the agreed maturity *ex post*.

<sup>37</sup> An exception applies where there is a restriction on the transfer of the existing credit exposure and this restriction only applies in the event of restructuring. In this case the limit described in paragraph 6 of this Attachment applies as if restructuring of the underlying exposure was not included within the terms of the credit derivatives contract.

- (i) it must clearly identify those parties responsible for determining whether a credit event has occurred. This determination must not be the sole right of the protection seller. An ADI buying the credit protection must have the right and ability to inform the protection seller of the occurrence of a credit event.
6. When restructuring of the underlying exposure is not included within the terms of the credit derivative contract but all other requirements of paragraph 5 of this Attachment are met, an ADI may recognise 60 per cent of the lesser of the amount of the credit protection purchased and the amount of the underlying exposure.
7. Where there is a mismatch between the underlying obligation and the reference obligation under the credit derivative, including the obligation used for the purposes of determining the cash settlement value or the deliverable obligation, an ADI may only recognise the credit derivative as eligible CRM if the following conditions are satisfied:
  - (a) the reference obligation ranks *pari passu* with, or is junior to the underlying obligation; and
  - (b) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.
8. Where there is a mismatch between the underlying obligation and the obligation used for the purposes of determining whether a credit event has occurred, an ADI may only recognise the credit derivative as eligible CRM if the following conditions are satisfied:
  - (a) the obligation used to determine whether a credit event has occurred ranks *pari passu* with, or is junior to, the underlying obligation; and
  - (b) the underlying obligation and the reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

*Eligible credit protection providers*

9. An ADI must only recognise credit protection provided by the following entities:
  - (a) sovereigns;
  - (b) banks;
  - (c) other entities that are externally rated, where credit protection is provided to a non-securitisation exposure. This includes credit protection provided by parent, subsidiary and affiliate companies where they have a lower risk weight than the obligor; and
  - (d) where credit protection is provided to a securitisation exposure, other entities with a credit rating grade of three or better and that were externally rated two or better at the time the credit protection was provided. This also

includes credit protection provided by parent, subsidiary and affiliated companies where they have a lower risk weight than the obligor.

#### *Materiality thresholds*

10. Where a credit derivative provides for a materiality threshold on payments below which no payment will be made in the event of loss, it is equivalent to a retained first loss position and must be deducted from Common Equity Tier 1 Capital in accordance with APS 111. This deduction will be capped at the amount of capital the ADI would be required to hold against the full value of the underlying exposure.

#### *Proportional and tranching cover*

11. Where there is partial coverage of an underlying exposure by a credit derivative and the protected and unprotected portions are of equal seniority (i.e. the ADI buying credit protection and the protection seller share losses on a *pro rata* basis), capital relief will be afforded on a proportional basis. This means that the protected portion of the underlying exposure will receive the capital treatment applicable to eligible credit derivatives with the remainder treated as unprotected.
12. Where there is partial coverage of an underlying exposure by a credit derivative and there is a difference in seniority between the protected and unprotected portions of the underlying exposure, then the arrangement is considered to be a synthetic securitisation and is subject to the requirements set out in APS 120.

#### *Currency mismatch*

13. A currency mismatch exists where an ADI has purchased credit protection using a credit derivative and the credit derivative is denominated in a different currency from that in which the underlying exposure is denominated. In this case the amount of the exposure deemed to be protected ( $G_a$ ) must be reduced by the application of a haircut ( $H_{fx}$ ) as follows:

$$G_a = G \times (1 - H_{fx})$$

where:

$G$  = nominal amount of the credit derivative

$H_{fx}$  = haircut appropriate for the currency mismatch between the credit derivative and the underlying exposure.

14. Where there is a currency mismatch, an ADI must apply a haircut of 8 per cent (based on a 10 business day holding period and daily marking-to-market). The haircut must be adjusted depending on the actual frequency of revaluation of the currency mismatch, in accordance with paragraph 36 of Attachment G to this Prudential Standard.

*Maturity mismatch*

15. A maturity mismatch exists where the residual maturity of a credit derivative is less than the maturity of the underlying exposure.
16. Where there is a maturity mismatch, a credit derivative may only be recognised as eligible CRM where the original maturity of the credit derivative is greater than or equal to 12 months and the residual maturity is greater than or equal to 3 months.
17. Where credit protection provided by a single protection seller to the same underlying exposure has different maturities, an ADI must divide the exposure into separate covered portions for risk-weighting purposes.
18. For the purpose of determining maturity:
  - (a) the effective maturity of the underlying exposure must be calculated using the longest possible remaining time before the counterparty is scheduled to fulfil its obligation; and
  - (b) for the credit derivative, an ADI that purchases credit protection must take into account any clause or incentive within the credit derivative contract that may reduce its maturity so that the shortest possible effective maturity is used.
19. Where there is a maturity mismatch, an ADI must apply the following adjustment:

$$P_a = P \cdot \frac{t - 0.25}{T - 0.25}$$

where:

- |       |   |
|-------|---|
| $P_a$ | = value of the amount of credit protection adjusted for maturity mismatch   |
| $P$   | = the amount of credit protection adjusted for any haircuts (in which case, $P = G_a$ as determined in paragraph 13 of this Attachment) |
| $t$   | = min (T, residual maturity of the credit derivative) expressed in years  |
| $T$   | = min (5, residual maturity of the underlying exposure) expressed in years.   |

**Sold credit protection**

20. Where an ADI uses credit derivatives for the purpose of selling credit protection, this Attachment must be read in conjunction with Attachments A to F of this Prudential Standard.

21. An ADI that sells credit protection that is not detailed in paragraphs 27 and 28 of this Attachment must, prior to execution of the relevant credit derivative contract, undertake a written assessment of the appropriate Regulatory Capital treatment for the transaction. The ADI must notify APRA prior to execution and provide its written assessment to APRA upon request. The ADI must apply the treatment set out in its written assessment unless APRA determines an alternative methodology for calculating the Regulatory Capital treatment.
22. Where an ADI uses total-rate-of-return swaps to hedge a banking book credit exposure in accordance with the requirements set out in this Attachment, those transactions must be included in the ADI's banking book. All other total-rate-of-return swaps must be included in an ADI's trading book.
23. Any instruments that would give rise to a net short credit or equity position in the banking book must be included in an ADI's trading book.<sup>38</sup>
24. An ADI that has sold credit protection using a credit derivative must, for capital adequacy purposes, assume that 100 per cent of the credit risk is purchased irrespective of the range of specified credit events.
25. An ADI that sells credit protection using a credit derivative containing an embedded option to extend the term of the credit derivative must assume the longest possible effective maturity of the credit derivative. This is regardless of any contractual arrangements that may give either the protection buyer or the protection seller the incentive to reduce the contract term.
26. When determining the amount of credit protection sold, an ADI must assume that any materiality thresholds included in the credit derivative contract do not reduce the acquired credit risk.

#### *Credit-default swaps*

27. Where credit protection is sold via a credit-default swap referenced to a single reference entity, the ADI acquires an exposure to the credit risk of that entity. The risk weight that must be applied to the exposure is the risk weight that would otherwise apply to the reference entity. The amount of the exposure is the maximum possible amount payable under the terms of the credit derivative contract if a credit event were to occur.

#### *First- and second-to-default basket credit derivatives*

28. An ADI which sells credit protection through a first-to-default or second-to-default credit derivative, must apply the following capital requirements to these exposures:
  - (a) for first-to-default credit derivatives, the risk weights of the assets included in the basket must be aggregated up to a maximum of 1250 per cent and

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<sup>38</sup> An ADI will have a net short risk position for equity risk or credit risk in the banking book if the present value of the banking book increases when an equity price decreases or when a credit spread on an issuer or group of issuers of debt increases.

multiplied by the nominal amount of the protection provided by the credit derivative to obtain the risk-weighted asset amount; and

- (b) for second-to-default credit derivatives, the treatment is similar; however, in aggregating the risk weights, the asset with the lowest risk-weighted amount can be excluded from the calculation. This treatment applies respectively for nth-to-default credit derivatives, for which the n-assets with the lowest risk-weighted amounts can be excluded from the calculation.