APS 113 - Residential mortgages extract

This document is an extract of *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) setting out the proposed revisions to the capital requirements for residential mortgages. For the purpose of this consultation:

- other requirements in APS 113 should be assumed to be unchanged, with the exception of the 1.06 factor in paragraph 17 of this Prudential Standard, which should not be applied; and
- ADIs should not consider the treatment of residential mortgage exposures in offshore subsidiaries, which will be consulted on as part of the later APS 113 consultation.

Asset class definition

1. An exposure is categorised as a retail exposure if all of the following criteria are met:

   (a) it is to an individual (that is, a natural person) or individuals;

   (b) it is part of a large pool of exposures that are managed by the ADI on a pooled basis; and

   (c) it is not either margin lending or lending for business purposes.

2. The residential mortgage sub-asset class includes retail exposures that are partly or fully secured by residential properties. An obligor that is not a natural person may also be included if the exposure is managed in a manner consistent with other residential mortgage exposures and all of the following criteria are met:

   (a) the obligor operates solely for non-business or non-trading purposes;

   (b) the obligor has less than five mortgaged residential properties; and

   (c) the exposure is guaranteed by a natural person or, in the case of a trust, all trustees or beneficiaries are natural persons.

Probability of default and loss given default estimates

3. The PD assigned to each pool of retail exposures is the greater of the one-year PD (refer to paragraph 71 of Attachment A to this Prudential Standard) associated with the internal obligor grade to which the pool of retail exposures is assigned and 0.05 per cent.

4. A 100 per cent PD must be assigned to default grades (refer to paragraph 76 of Attachment A to this Prudential Standard).

5. An ADI must apply a LGD of 20 per cent across the residential mortgage sub-asset class, unless the ADI's own estimates have been approved by APRA. An

ADI with approval to use its own estimates must apply a minimum LGD of 10 per cent to each exposure in the sub-asset class.

6. An ADI's own estimates of LGD for the residential mortgage sub-asset class must not reflect recoveries from lenders' mortgage insurance (LMI). An ADI may recognise LMI by applying a 20 per cent reduction to its own estimates of LGD for residential mortgage exposures with LMI provided that:

   (a) the LMI meets the requirements in Attachment A to APS 112; and

   (b) the loan-to-valuation ratio (LVR), as defined in APS 112, of the exposure is greater than 80 per cent.

   The LGD after recognition of LMI must not be less than the minimum LGD as set out in paragraph 5 of this Attachment.

Exposure measurement for off-balance sheet exposures except those that expose the ADI to counterparty credit risk

7. For off-balance sheet exposures, EAD is calculated as the notional amount of the exposure multiplied by a CCF or, in the case of an undrawn commitment, the undrawn amount multiplied by a CCF.

8. Subject to the minimum requirements detailed in paragraphs 101 to 107 and 109 of Attachment A to this Prudential Standard, an ADI may use its own internal estimates of CCFs for revolving retail exposures. Revolving exposures are those exposures where customers' outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to a limit established by the ADI. This does not include exposures that allow prepayments and subsequent redraws of those prepayments.

9. EAD for a revolving retail exposure must not be less than the sum of: (i) the on-balance sheet amount; and (ii) 50 per cent of the off-balance sheet exposure using the applicable CCF in Attachment C to APS 112.

10. For non-revolving retail exposures, ADIs must use the CCFs set out in Attachment C to APS 112.

Risk-weighted assets for the residential mortgage sub-asset class

11. For non-defaulted exposures in the residential mortgage sub-asset class,[1] the risk-weight function is:[2]

    Correlation (R) = 0.15

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[1] The residential mortgage risk-weight function also applies to the unsecured portion of residential mortgages that are partly secured by residential property.

[2] N (x) denotes the cumulative distribution function for a standard normal random variable (i.e. the probability that a normal random variable with mean zero and variance of one is less than or equal to x). G (z) denotes the inverse cumulative distribution function for a standard normal random variable (i.e. the value of x such that N (x) = z).

$$\text{Capital requirement (K)} = \left[LGD \times N\left(\frac{G(PD) + \sqrt{R} \times G(0.999)}{\sqrt{1-R}} \right) - PD \times LGD \right]$$

12. For non-defaulted exposures that meet the definition of an owner-occupied and principal-and-interest mortgage as specified in Attachment A to APS 112, risk-weighted assets are calculated as:

RWA = K x 12.5 x EAD x 1.5

13. For other non-defaulted residential mortgage exposures, risk-weighted assets are calculated as:

RWA = K x 12.5 x EAD x 2

Exposures subject to the standardised approach for risk weighting

14. For exposures that meet the definition of a non-standard mortgage as set out in paragraphs 16 and 17 of Attachment A to APS 112, ADIs must apply the risk-weighting approach as specified in APS 112 to calculate risk-weighted assets.