Australian Prudential Regulation Authority

400 George Street (Level 26)
Sydney NSW 2000

GPO Box 9836
Sydney NSW 2001

T 02 9210 3000
F 02 9210 3411
W www.apra.gov.au

10 January 2014

To all ADIs accredited to use the internal ratings-based (IRB) approach to credit risk

Clarification of IRB regulatory capital and reporting requirements

APRA has observed a number of inconsistencies across the industry in the IRB regulatory capital and reporting treatment of certain products/exposures. Additionally, some practices are not consistent with the intent of *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) and the associated reporting standards.

To facilitate consistency in IRB capital and reporting treatment across ADIs and clarify APRA's expectations, APRA is issuing guidance in the following areas: firm-size adjustment for corporate exposures; best estimate of expected loss (EL) for defaulted assets; and SME retail.

APRA requests that ADIs provide confirmation by **21 February 2014** to their Responsible Supervisor as to whether or not their existing practices are fully consistent with this guidance. Where gaps against APRA's expectations exist, ADIs should discuss with their Responsible Supervisor how and when they intend to close those gaps.

1. Firm-size adjustment for corporate exposures

1.1 As set out in paragraph 81 of Attachment B to APS 113, a firm-size adjustment may be applied to obligors that form part of a corporate group with reported consolidated annual sales of less than $50 million. For the purposes of applying this adjustment, the definition of corporate group should be consistent with paragraph 14 of *Prudential Standard APS 221 Large Exposures* (APS 221) i.e. two or more individual counterparties that are linked by:

- cross guarantees;
- common ownership or management;
- the ability to exercise control over the other(s), whether direct or indirect;
- financial interdependency such that the financial soundness of any of them may affect the financial soundness of the other(s); or
- other connections or relationships which, according to an ADI's assessment, identify the counterparties as constituting a single risk.

Transactions between obligors that form part of a corporate group may be netted off for the purposes of determining the firm size of that group.

2. Best estimate of EL for defaulted assets

2.1 Under the advanced IRB (AIRB) approach and the IRB approach for retail exposures, EL for a defaulted asset must be based on current economic circumstances and the facility's status (APS 113, paragraph 19(b)). APRA does not accept the simple application of long-run average or downturn loss given default (LGD) estimates as the best estimate of EL on a defaulted asset.

2.2 Instances where the best estimate of EL on a defaulted asset is less than the sum of specific provisions and partial write-offs on that asset must be justified to APRA (APS 113, Attachment A, paragraph 98).

3. SME retail

3.1 For SME retail exposures that are fully or partly secured by residential properties, an ADI must use the residential mortgage risk-weight function (as defined in paragraph 35 of Attachment C to APS 113) to calculate the minimum capital requirement for those exposures.

3.2 As set out in paragraph 47 of APS 113, the $1 million threshold for SME retail exposures applies to the total business-related exposure of the consolidated banking group to a small-business obligor or group of connected small-business obligors. This includes business-related exposures that are fully or partly secured by residential properties.

3.3 For the purposes of the $1 million retail threshold, the definition of a group of connected small-business obligors should be consistent with paragraph 14 of APS 221 i.e. two or more individual counterparties that are linked by:

- cross guarantees;
- common ownership or management;
- the ability to exercise control over the other(s), whether direct or indirect;
- financial interdependency such that the financial soundness of any of them may affect the financial soundness of the other(s); or
- other connections or relationships which, according to an ADI's assessment, identify the counterparties as constituting a single risk.

3.4 Consistent with *Reporting Standard ARS 113.3 Internal Ratings-based Approach to Credit Risk - Retail*, all small-business exposures that meet the criteria for retail treatment in paragraph 47 of APS 113 should be reported in ARF 113.3D: IRB Retail - SME. This includes SME retail exposures that are fully or partly secured by residential properties and for which the minimum capital requirement is calculated using the residential mortgage risk-weight function.

If you have any questions in relation to this letter, please contact your Responsible Supervisor.

Yours sincerely

Barton Ashcroft
Senior Manager- Data Collections